The Content and Impact of Bank Supervision

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The Role of Supervision

- Moral Hazard: Monitor compliance with regulation
  - Detect hidden actions
  - Rule based: "Compliance and regulation"
- Complexity: Monitor bank practices that are not easily "codifyable"
  - Deviations from sound practice: "I know it when I see it"
  - Soft dimensions: "internal controls", "
- Dynamic Market: Identify new dimensions of bank activity that can possibly affect stability
  - Supervisors as front line for new regulatory actions

➔ List of tasks increasing in discretion

Challenges for Supervisors

- Trust relationship: Advice versus oversight
  - Fine balance to make bank share information while being supervised
  - Trade-off between punitive measures and trust building
  - Are there different styles in using supervisory tools: MRA (or MRIA)

- Intellectual independence: “Group Think”
  - Psychology research: “Empathy for subject”, susceptibility to “framing”
  - Do supervisors maintain independence over time?
  - Do they have resources, time to step out of ”rate-race” inside the bank?

- Idiosyncratic versus systemic view of bank violations
  - Do supervisors take macro-dynamics into account?
  - Aggregation of supervisory information across banks

Production Function of Supervisors

- Supervisory Trade-off
  - Is there a cost-benefit trade-off to identify current small infractions vs large longer-run risks?
  - Supervisory discretion can stifle delivery of bank services
  - Problems of type 1/type 2 errors in supervision: best supervisors might anticipate problems before they become a discrete offense; "nudge" people in the right direction without MRAs
- Time dimension of supervision
  - Quality-quantity trade-off, e.g. experienced supervisors use less time to get same output?
  - Is time spent endogenously driven by banks' willingness to comply or quality of data management of the bank?
- What are implicit and explicit incentives of supervisors?
  - Challenge to incentivize agents for outcomes that "did not happen"? How do they take into account lending externalities to economy
  - Issues of revolving door between industry and supervision?

Idiosyncratic Supervisor Effects

- Use change in supervisor within bank to test supervisory discretion/styles
  - Do styles of supervision vary? Effectiveness of supervisors?
  - Ex ante classify dimensions of ability, experience or styles
  - Turnover due to illness, retirement provides exogeneity
    - E.g. Bertrand and Schoar (2003), Drexler and Schoar (2013)

- Longitudinal analysis of supervisory spells to test dynamics
  - Do supervisors become more effective over time? Does use of supervisory tools change with time, e.g. more discretion less rule based?
  - Are there big "resets or clean-up events" when new supervisor comes in
    - E.g. Herzberg and Paravisini (2008)

Competitive Landscape

- Does supervision create equilibrium spill over effects to other banks?
  - Externalities: Does greater attention to the top 5 banks allow others to fill in the riskier products? Do less strictly supervised banks have higher market share in riskier products?
  - Competitive Dynamics: Regions with many large banks (non-top 5 banks that can serve as control for a top 5 bank) might overall be more competitive.
  - Also do RDD *within* a geographic areas – would hold competitive dynamics within a region constant

- Is there strategic selection of bank size to avoid stricter supervision?
  - Look at bunching and self selection of banks
  - Show full distribution of attention by size rank, not just top 5 average?

Idiosyncratic versus Systemic Risks

- Supervision over the business cycle
  - Look at how types of violations change over the business cycle
  - Does supervisory evasion increase in boom times, e.g. off balance sheet activities
  - Correlation between analysts and supervisors is driven by observable firm fundamentals. Can you see if the is a predictive part of supervisory actions on future bank performance changes over the business cycle?
- Can supervisory comments be aggregated up to providing a view on the state of the banking industry?
  - Can textual analysis in real time provide feedback to supervisors about industry changes?
  - Do supervisors get carried away too!
- Might help to understand the dynamics of banking crises
  - Are banks violating rules or making mistakes due to optimistic (biased) believes?

And of course …

…. A pitch for making data available to researchers!

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