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Comments on the paper

Bank Supervision Going Global? A Cost-Benefit Analysis

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Standard reservations apply

The basic model:

$$\lambda R - (1-\lambda)c_2 = 1 - c_1.$$

$$\lambda^* = \frac{1 + c_2 - c_1}{R + c_2}.$$

Lambda is the probability of success, R is return. C1 and C2 are costs imposed on others in period 1 (if intervention takes place) and in 2 of project fails

The outcomes are the following:

If intervention takes place in period 1, equity holders and depositors get everything back, but a third unidentified party loses C1.

In period 2, shareholders and depositors may either get their investment back (shareholders get also the profit), or they may lose everything and impose a loss of C2 on "others". .

The regulator is blind in respect to residency of the shareholders, the depositors, or "third parties".

The above equation sets a threshold for lambda, the probability of success, at which the expected payout in both cases (intervention and non-intervention) are equal. If lambda is below the threshold, the regulator intervenes.

Comment 1:

"An increase to the same extent in external costs of both c_1 and c_2 will make intervention in period 1 more likely,...". (page 4).

Is this right? Both C1 and C2 higher imply a lower lambda. Lower lambda implies fewer interventions, not more.

The "national" regulator who cares only about the payout to residents:

$$\lambda(\gamma_D d + \gamma_E(R - d)) - (1 - \lambda)\gamma_A c_2 = \gamma_D d + \gamma_E(1 - d) - \gamma_A c_1.$$

ng for λ gives

$$\widehat{\lambda} = \frac{\gamma_D d + \gamma_E(1 - d) + \gamma_A(c_2 - c_1)}{\gamma_D d + \gamma_E(R - d) + \gamma_A c_2}.$$

For C1=0,

$$\widehat{\lambda}'(\gamma_D) = \frac{(R - 1)d\gamma_E}{(\gamma_D d + \gamma_E(R - d) + \gamma_A c_2)^2} > 0$$

Comment 2:

"A higher share of domestic deposits, in turn, makes the domestic regulator less inclined to gamble on bank success in the second period. Hence, with a higher share of domestic deposits, the domestic regulator becomes ***less likely to intervene***, that is, the range of lambdas where interventions takes place increases." (page 6)

Is the regulator indeed less likely to intervene if the share of domestic deposits is higher?

No. The logic is simple: In T1, the regulator can always get the deposits fully paid out. (In this case, as assumed by the authors, even the third-party loss is zero, i.e. C1=0). If we look at two regulators, one having a large share of domestic deposits and the other low, ceteris paribus, for the same likelihood of the success of the project, the first will have stronger incentives to intervene, i.e. it will intervene even at higher lambdas. (Lambda is probability of success.) That means that the likelihood of intervention will be higher, not lower. The authors themselves state this fact when they say that "the range of lambdas where interventions takes place increases."

Taken to the extreme, if there are no domestic shareholders, no costs for third domestic parties, the domestic regulator will intervene in all cases except when lambda=1, i.e. the success is guaranteed. Which means it will intervene always.

Therefore, with a higher share of domestic deposits, the regulator **is more likely** to intervene.

Comment 3: No third-party costs for the taxpayers, only for borrowers

$$\lambda(\gamma_D d + \gamma_E(R - d)) - (1 - \lambda)\gamma_A c_2 = \gamma_D d + \gamma_E(1 - d) - \gamma_A c_1. \qquad (3)$$

The costs of unspecified third parties C2 in this formula is implied to depend on the share of domestic assets in total assets. This is a more narrow interpretation than mentioned by the authors in their text ("The intervention is assumed to cause in addition costs c_1 external to the bank, arising for example from the disruption that depositors and borrowers might experience during the intervention.").

If third party costs are modeled this way, i.e. if they depend on the share of domestic assets in total assets, this means that they are effectively costs imposed on domestic borrowers. This is an overly restrictive definition. Its usefulness is limited, and as it does not permit the assessment of other aspects of cross-border assets structure on the decision about the bank. Moreover, the model does not include costs for the taxpayers.

Comment 4: Supervisor and/or Central Planner

The regulator in the model is presented as being similar to a central planer, who maximizes the aggregate pay-out for shareholders, depositors and third parties.

Is this really the role of the regulator? Should he/she not focus on depositors (and taxpayers), and let the shareholders take care of themselves?

The model, however, does not allow this, as the depositors do not have any priority relative to the shareholders. In T1 if the regulator intervenes, both depositors and equity holders get their investments fully back. In T2, they either lose everything, or the depositors get deposits back and the shareholders get their investment plus profit. Depositors look in this model more like junior partners, than depositors whose interests are protected by the supervisor.

Comment 5: Is the national bias of supervisors really a problem?

The basic idea of the authors is that domestic regulators might be biased in their decisions toward domestic stake-holders (depositors, shareholders, borrowers). In principle, this is plausible.

By defining the problem in this way, the authors implicitly argue in favor of establishing a global, or perhaps an EU level of supervision. (Supervision going global?) Admittedly, they say add additional requirements like the availability of information and necessary mechanisms. (They note that various biases to which domestic regulator is exposed might offset each other, but such coincidence cannot matter in choosing the optimal level of supervision.)

But how much evidence is there that this bias has indeed surfaced during the current crisis?

There does not seem any.

For example, there is no evidence or even indications that **the US** authorities were led by such considerations in letting the Lehman Brothers fail. **The US let numerous other American** banks to fail, and in no cases this appeared to reflect some national bias.

In the case **of AIG**, the large exposure to European banks did not prevent the US authorities from saving it, despite the sizable costs.

The UK has saved all its biggest banks despite their high share of foreign liabilities.

In other cases **(e.g. Austria and similar**), governments that supported their banks did not seek participation of other countries in which these banks had operated.

In the case of **Fortis,** one country nationalized the subsidiary, but there are no reasons why should not be seen as appropriate decision.

It was only **Island** that tried to discriminate against foreign depositors. It backfired. One could perhaps say that this is because Island is a small country. However, within the EU, non-resident depositors and creditors would have many other legal means to defeat measures that would discriminate against them.

More than supporting the case for supra-national supervision, the case of Island raises the issue whether **large branches** should be left operating without effective host supervision. In fact, they should obviously not.

The authors would perhaps say that it is not discrimination they tried to model. Indeed, their model treats non-resident and resident depositors and shareholders equally in terms of the pay-out. It is just the different mix of deposit/equity that makes a difference in the reaction function of a domestic supervisor versus an international supervisor. The only discrimination that their model allows is in respect to "the third party costs". However, this makes the differences in the reaction functions even less material.

Comment: The case for bank supervision going global is weak (except for strengthened surveillance)

The current system of a primary role of national supervision worked during the current crisis.

There is no evidence that the absence of common European framework for bank resolution prevented the implementation of effective measures in case of large cross-country banks.

The link between the supervision decisions and final fiscal responsibility is inseparable. This is not only because of the need to internalize costs of decisions. It also reflects considerations of political economy in the banking supervision.

Financial lobby is extremely powerful. It operates not only on national levels, but also on the level of international organizations and EU institutions.

The only chance to have it contained is to have it confronted by interest of taxpayers, which can only be done on the national level.

Therefore efforts to develop and define set of international best practices are useful, as it is the increased cooperation of supervisors.

However, the proposals for raising the supervision to supranational levels might be more distracting than useful.

Strengthening the national supervision is crucial. The light-touch regulation and focus on formal conformity with rules have to go. We need a heavy-touch supervision focused on substance and with large discretionary powers, and large resources. This is more important than to diminish national responsibility for supervision by moving toward global level.