MONETARY POLICY & BANK SUPERVISION UNDER THE SAME INSTITUTION

Vasso Ioannidou

Tilburg University

Banking Supervision and Central Banks: Insights from Research

ECB Workshop, June 26 2013
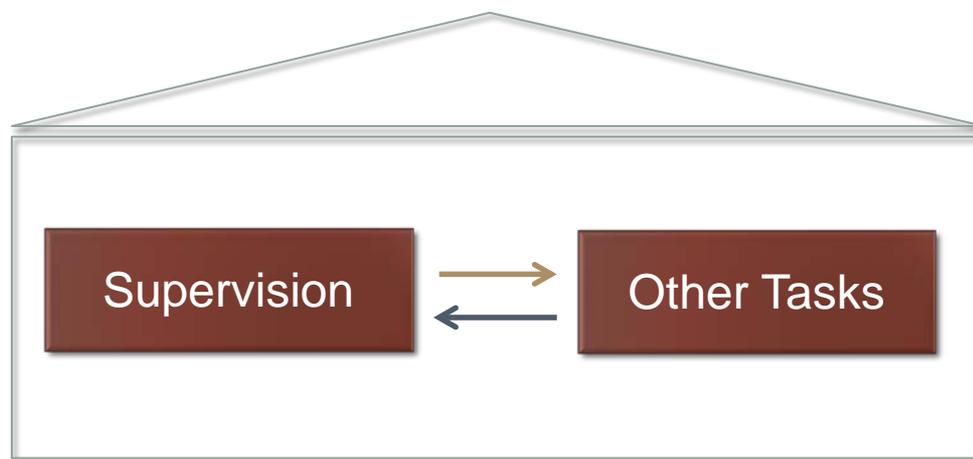
Overview

- What are the most commonly cited implications of giving Central Banks a bank supervisory role?

  - Quick overview
  - Empirical relevance
  - Banking union implications

Implications

- Giving a central bank a bank supervisory responsibility is often argued to alter its behavior with respect to some of its other tasks. These other responsibilities are also argued to influence a Central Bank's behavior as a supervisor.

Implications

- Giving a central bank a bank supervisory responsibility is often argued to alter its behavior with respect to some of its other tasks. These other responsibilities are also argued to influence a Central Bank's behavior as a supervisor.

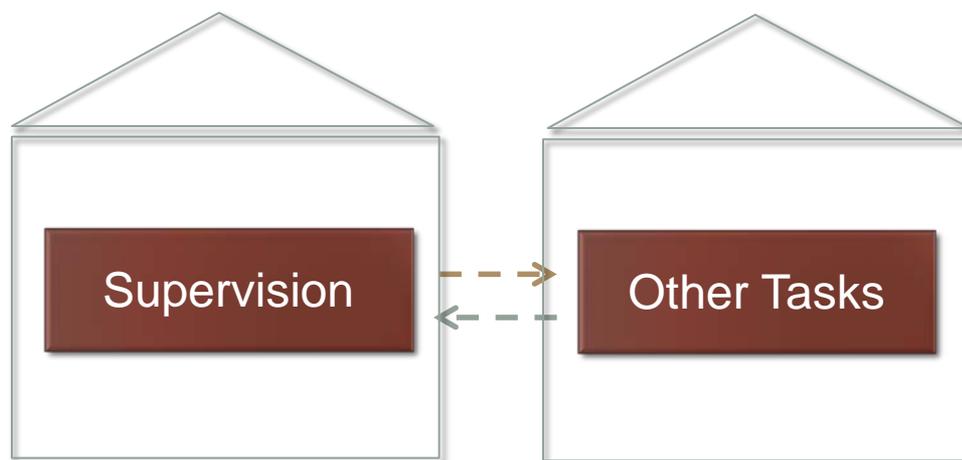# Implications

- Giving a central bank a bank supervisory responsibility is often argued to alter its behavior with respect to some of its other tasks. These other responsibilities are also argued to influence a Central Bank's behavior as a supervisor.
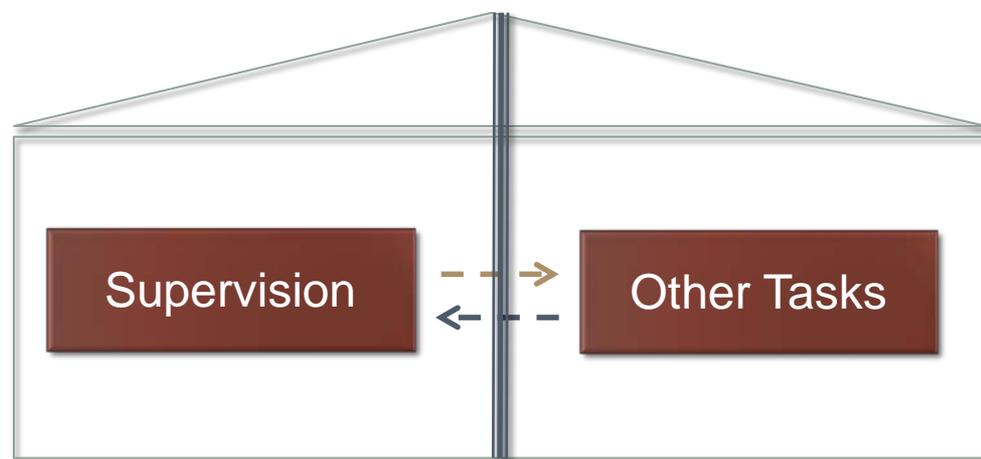
Implications

- Giving a central bank a bank supervisory responsibility is often argued to alter its behavior with respect to some of its other tasks. These other responsibilities are also argued to influence a Central Bank's behavior as a supervisor.

| Supervision | → ← | Other Tasks |

Chinese walls?
Do they work?

Supervision → Lender of Last Resort

- To act appropriately in its LOLR function, a Central Bank must have accurate and unbiased knowledge of the exact situation of the banks for which it is supposed to act as a LOLR in real time, which often requires supervisory responsibility.

Supervision → Lender of Last Resort

- To act appropriately in its LOLR function, a Central Bank must have accurate and unbiased knowledge of the exact situation of the banks for which it is supposed to act as a LOLR in real time, which often requires supervisory responsibility.

- The channeling of accurate and unbiased information from other institutions that do not necessarily share the same incentives cannot be trusted, … especially during crises periods when there is no time or sufficient information to gather an own opinion and transferred info is more likely to be inaccurate or biased.

Supervision → Lender of Last Resort

- To act appropriately in its LOLR function, a Central Bank must have accurate and unbiased knowledge of the exact situation of the banks for which it is supposed to act as a LOLR in real time, which often requires supervisory responsibility.

- The channeling of accurate and unbiased information from other institutions that do not necessarily share the same incentives cannot be trusted, … especially during crises periods when there is no time or sufficient information to gather an own opinion and transferred info is more likely to be inaccurate or biased.
  - E.g., supervisory data need "interpretation" – soft info non-transferable
  - E.g., supervision sometimes are under ministries of finance, typically less independent than most central banks

Supervision → Lender of Last Resort

- To act appropriately in its LOLR function, a Central Bank must have accurate and unbiased knowledge of the exact situation of the banks for which it is supposed to act as a LOLR in real time, which often requires supervisory responsibility.

- The channeling of accurate and unbiased information from other institutions that do not necessarily share the same incentives cannot be trusted, … especially during crises periods when there is no time or sufficient information to gather an own opinion and transferred info is more likely to be inaccurate or biased.
  - E.g., supervisory data need "interpretation" – soft info non-transferable
  - E.g., supervision sometimes are under ministries of finance, typically less independent than most central banks

EZ

Supervision → Monetary Policy

- Conflicts of Interest and Reputation Risks

  - The public and politicians often blame the supervisory authority for the crises that do occur, but do not give credit to supervisors for crises and failures that are successfully prevented.

  - Such pressures create incentives for "regulatory forbearance" when problems begin to mount.

  - An integrated approach may aggravate such problems: the "captured supervisor" in this case in may have access to an "unlimited" pot

Supervision → Monetary Policy

- Conflicts of Interest and Reputation Risks

    - The public and politicians often blame the supervisory authority for the crises that do occur, but do not give credit to supervisors for crises and failures that are successfully prevented.
    - Such pressures create incentives for "regulatory forbearance" when problems begin to mount.
    - An integrated approach may aggravate such problems: the "captured supervisor" in this case in may have access to an "unlimited" pot

    - If banks view this as access to a larger "put option", their incentives to take on more risk ex-ante are also likely to increase
    - … and the central banks' reputation and credibility in preserving price stability is likely to suffer.

Key Questions

- To what degree conflicts of interests and reputation costs are empirically relevant?
  - Evidence mixed (next slide)

- What institutional setup would minimize such conflicts, bailout expectations, and moral hazard?
  - Is a role in the "end-game" a minimum necessary condition?
    - End-game determines how institutions live

Empirical Relevance

- CBs with supervisory responsibilities are found to have worse track record in fighting inflation
  - Heller (1991), Goodhart and Schoenmaker (1992),
  - Di Noia and Di Giorgio (1999) – controls for CB independence

- Countries where CBs are involved in bank supervision have on average fewer bank failures
- Less government money and more commercial bank funds are used to resolve bank failures in countries where CBs have bank supervisory responsibilities
  - Goodhart and Shoenmaker (1995)

- Caveat: omitted country characteristics may be an issue

Supervision → Monetary Policy

- Confidential information obtained from bank supervision could improve the accuracy of economic forecasting and thus result in a more efficient contact of monetary policy

- Why would supervisory info improve economic forecasting?

  - Problems in the banking sector may serve as early indicators of deteriorating macroeconomic conditions more generally
  - To the extent that the lending channel is operative, advance notice of changes in bank lending behavior could also help predict resulting changes in macroeconomic conditions

Empirical Relevance

- Peek, Rosengren, and Tootel (1999)
  - Confidential supervisory information on the health of the banking sector (e.g., CAMELS ratings) is not incorporated by the Federal Reserve staff in its Greenbook forecasts of quarterly inflation rates and unemployment rates, …
  - … despite that such information is found to improve the forecast errors in inflation rates and unemployment.
  - However, this confidential information is found to be taken into account when setting monetary policy: affects the voting of FOMC members
  - => No Chinese walls
  - Confidential info is found to be more important for larger, systemic institutions, where supervisory data may need more "interpretation"

- Questions:
  - Which of these results hold in most recent periods?

Monetary policy → Supervision

- A central bank may use bank supervision to complement the objectives of monetary policy

- A unified approach may also allow a CB to better internalize and react to unintended consequences that monetary policy may have on banks risk-taking incentives
  - See, e.g., Ioannidou et al. (2013) and Jiménez et al. (2013)

Empirical Relevance

- Ioannidou (2005)
  - FED vs. OCC and FDIC in interventions into troubled institutions
  - => No Chinese walls
  - => The hypothesis in which FED is using not bank supervision to complement MP objectives is not supported by the data

  - Analysis:
    - All insured commercial and savings banks in the US
    - All formal actions against these institutions btwn 1990-1998
      - Publicly available as of 1989
      - Imposition not automatic: there is sufficient subjectivity that allows for a miningful comparison

Monetary Policy → Supervision

Table 4: The Effect of Monetary Policy on the Probability of Getting a FA

	Regressors	(1)	(2)	(3)	(4)	(5)
…						
Supervisor Specific	OCC	.2337*** (.0557)	.2417*** (.0556)	−.1302 (.1542)	−.1406 (.1545)	−.1647 (.1539)
	FDIC	−.1822*** (.0572)	−.1734*** (.0571)	−.5495*** (.1582)	−.5511*** (.1588)	−.5638*** (.1563)
Monetary Policy	$(FFunds)_{t-1}$		−.0098 (.0092)			
	$FED \times (FFunds)_{t-1}$			−.0728*** (.0252)	−.0709*** (.0251)	−.0757*** (.0253)
	$FDIC \times (FFunds)_{t-1}$			−.0040 (.0134)	−.0026 (.0134)	−.0064 (.0130)
	$OCC \times (FFunds)_{t-1}$			−.0048 (.0119)	−.0023 (.0130)	−.0059 (.0119)
Macro Indicators	$G(RGDP)_{t-1,t-4}$		−.0910*** (.0084)	−.0920*** (.0084)		−.0992*** (.0074)
	$(Sune - Nune)_{t-1}$		.0549*** (.0126)	.0549*** (.0126)	.0590*** (.0127)	.0606*** (.0118)
	$\Delta Nune_{t-1,t-4}$				.3058*** (.0248)	
	Observations	244,559	244,559	244,559	244,559	360,725
	Pseudo R^2	.2822	0.2742	0.2748	0.2782	0.2786

Notes: ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively. Robust standard errors in parenthesis. Regional dummies are included in all specifications. Quarterly dummies are included only in column (1).

Monetary Policy → Supervision

Table 5: Business Cycle and Interest-Rate Risk

Regressors	(1)	(2)	(3)	(4)	(5)
$FED \times G(RGDP)_{t-1}$	$-.0806^{***}$ (.0310)				
$FDIC \times G(RGDP)_{t-1}$	$-.0833^{***}$ (.0129)				
$OCC \times G(RGDP)_{t-1}$	$-.0990^{***}$ (.0110)				
$FED \times \Delta Nune_{t-1,t-4}$		$.2287^{**}$ (.0927)			
$FDIC \times \Delta Nune_{t-1,t-4}$		$.2578^{***}$ (.0384)			
$OCC \times \Delta Nune_{t-1,t-4}$		$.2561^{***}$ (.0381)			
$FED \times GAP1/A$			.0042 (.0039)		
$FDIC \times GAP1/A$			.0022 (.0018)		
$OCC \times GAP1/A$			$-.0015$ (.0018)		

…

Monetary Policy → Supervision

Table 5: Business Cycle and Interest-Rate Risk (Continued from previous page)

	Regressors	(1)	(2)	(3)	(4)	(5)
	FED×GAP2/A				.0036 (.0099)	
	FDIC×GAP2/A				−.0032 (.0022)	
	OCC×GAP2/A				−.0012 (.0021)	
	FED×Derivatives/A					.0095*** (.0003)
	FDIC×Derivatives/A					.0013* (.0008)
	OCC×Derivatives/A					−.0057* (.0031)
Monetary Policy	FFunds$_{t-1}$	−.0098 (.0092)	−.0078 (.0093)	−.0095 (.0092)	−.0096 (.0093)	−.0099 (.0092)
Business Cycle	G(RGDP)$_{t-1}$			−.0909*** (.0084)	−.0911*** (.0084)	−.0914*** (.0084)
	(Sune -Nune)$_{t-1}$	.0553*** (.0127)	.0560*** (.0127)	.0545*** (.0126)	.0548*** (.0126)	.0542*** (.0126)
	Observations	244,559	244,559	244,559	244,559	244,559
	Pseudo R^2	.2743	.2781	.2746	.2744	.2749

Notes: ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively. Robust standard errors in parenthesis. Regional dummies are included in all specifications.