Regulatory Banking Unions

European Central Bank Workshop

June 26th, 2013

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Motivation

- Possible silver lining of the crisis: Birth of EU-wide financial regulation in large scale.

- European Banking Authority (EBA), created in 2010, in charge of bank stress tests.

- European System Of Financial Supervision (ESFS). Coordinating financial services supervision (banking, securities, insurance) across Eurozone/EU.

But Banking Prudential Supervision rests with National Authorities

→Not Integrated within EU27 nor Euro17
→Not Fit for Cross-border Entities

Motivation

In an environment where cross-border banking/financial contagion prominent, many wonder whether institutional framework needs restructuring. See William Dudley's remarks on 4/22/12.

- "*Part of the difficulties we saw in 2008 was in Lehman, when push came to shove, the regulators stopped talking to each other,*" another executive said.

- "*Everything that you hear, including 'Do your resolution refresh with the assumption that authorities aren't speaking to each other', shows that we haven't made any progress in one of the key areas.*"

Financial Times 1/27/2013

Motivation

- Nonetheless, banking union proposal's true rationale:

1. Stem flow of deposits from Southern European banks in the short term.

2. Backstop in propagation of bank balance sheet troubles in periphery and kill the feedback cycle on/from sovereign debt on bank balance sheets.

These are important current (but short-term) concerns. See Elliott (Brookings 2012).

SSM

- Sept 2012, European Commission: Proposal for a **Single Supervisory Mechanism** (SSM) for banks.

New regulation giving new & strong powers to European Central Bank (ECB). Some medium-term pillars include:

1. Single "**Rule Book**";
2. **Common Deposit Insurance** Protection;
3. Single Bank **Resolution** Mechanism.

SSM

New Role for ECB as Super-National Prudential Regulator:

→Licensing/Authorizing
→Assessing qualifying holdings
→Ensuring compliance in regulatory capital requirements
→Carrying out preemptive intervention measures.

But:

→On-site examinations left to National Supervisors (w/ possible ECB “opt-in”)
→National Supervisors still assess validity of internal risk models (for assets risk weighting for regulatory ratios).

SSM: The US as laboratory for EU

- But effectiveness of regulation depends also on **how it is implemented** ("will of the regulator")

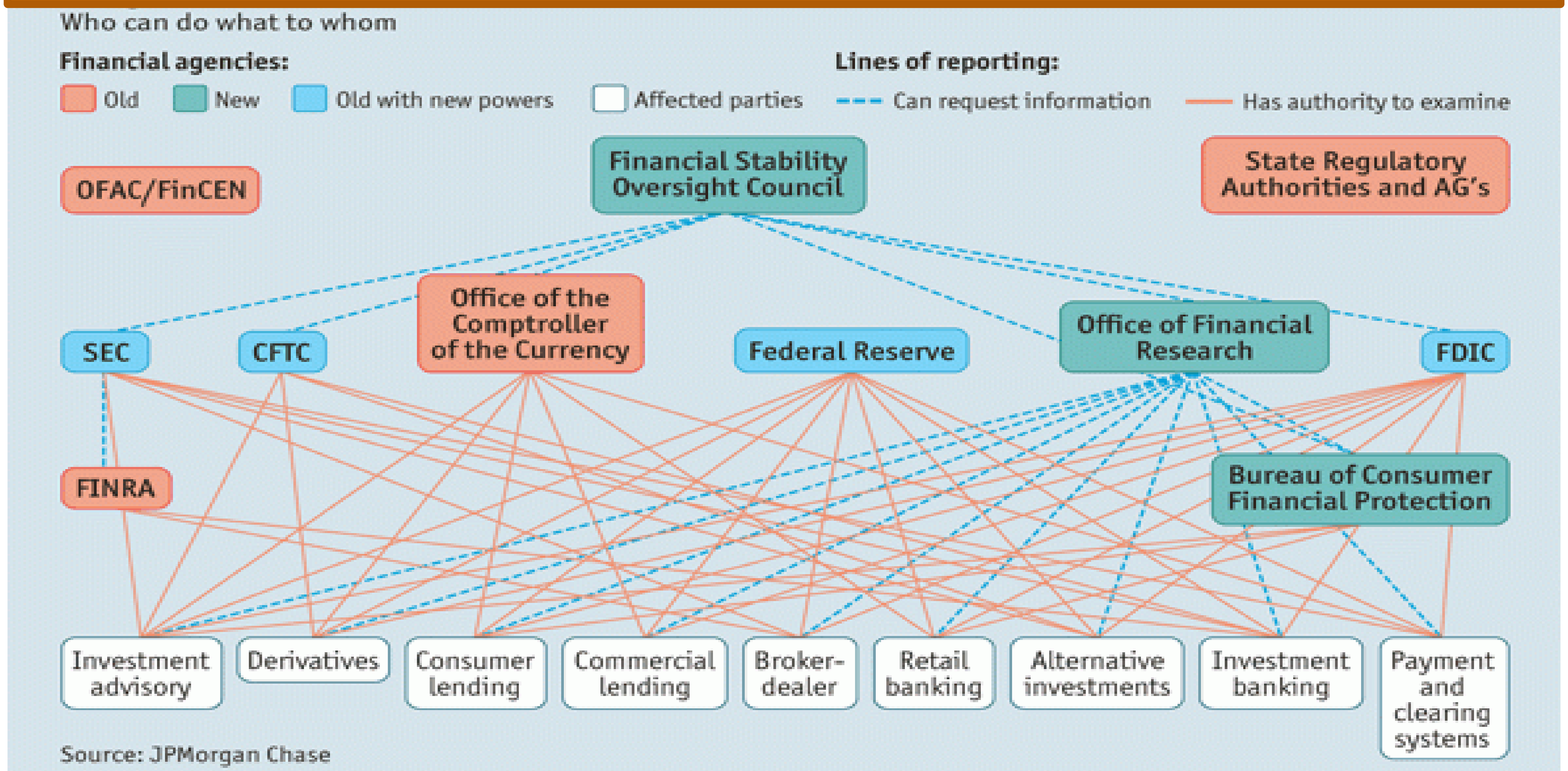
  - The SSM is surprisingly running very thin of empirical evidence justifying some important design choices.

  - Regulatory architecture critical when regulators have overlapping jurisdictions. Important case study is the US dual banking system.

  - US dual banking is one of the few instances for which some systematic empirical evidence is available.

Much of what follows based on joint work: Agarwal, Lucca, Seru, Trebbi (2012) & work in progress Lucca, Seru, Trebbi (2013).

Overlapping US Financial Regulators



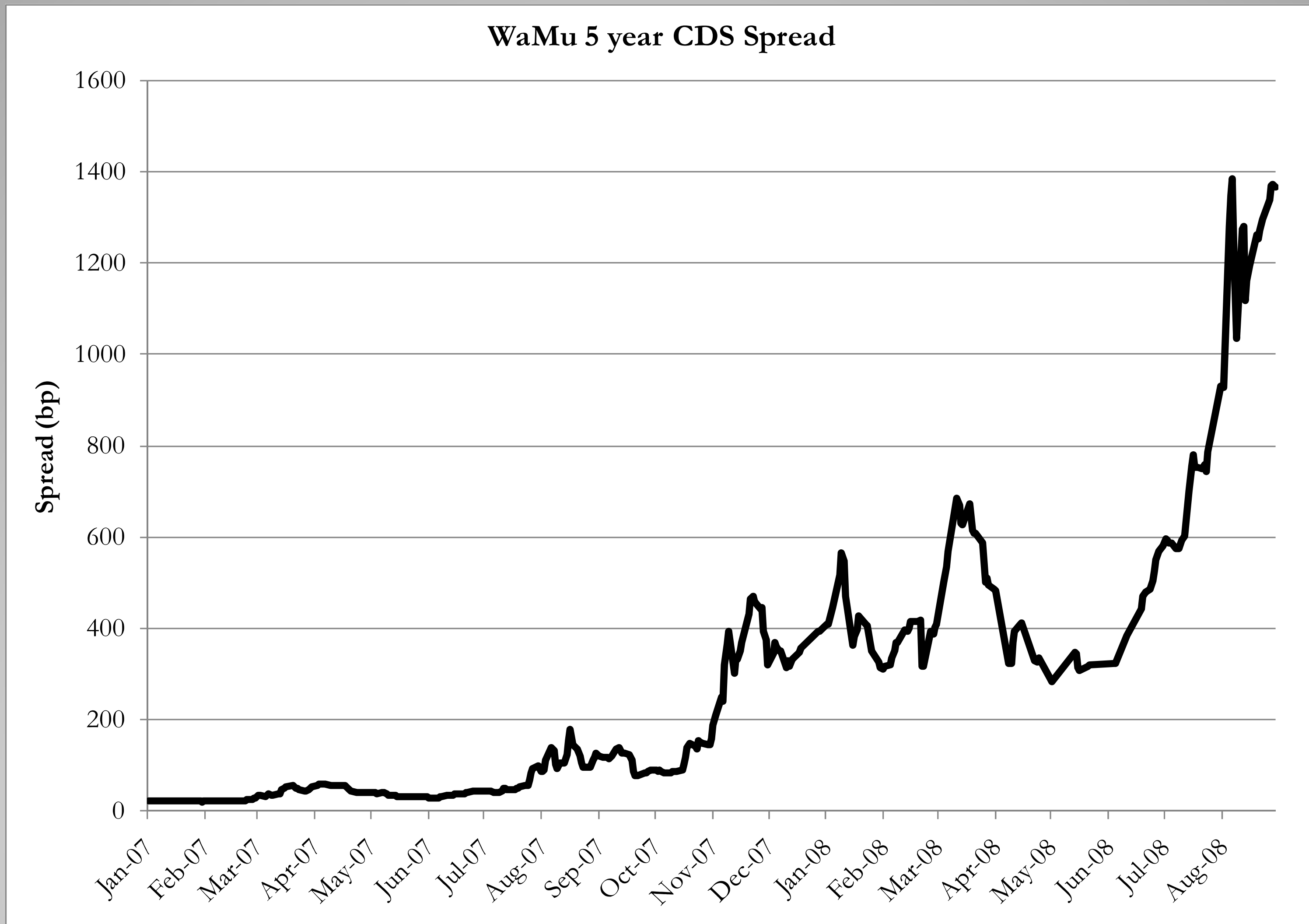
Motivation

- Effectiveness of regulation depends also on how it is implemented ("will of the regulator")

    - Important when regulators have overlapping jurisdictions
    - …and **different incentives and institutional design**.

- Plenty of anecdotes where differences along these margins delayed effective implementation during financial crisis:

        - OTS /FDIC & Washington Mutual



WaMu 5 year CDS Spread
Spread (bp)
1600
1400
1200
1000
800
600
400
200
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Feb-07
Mar-07
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May-07
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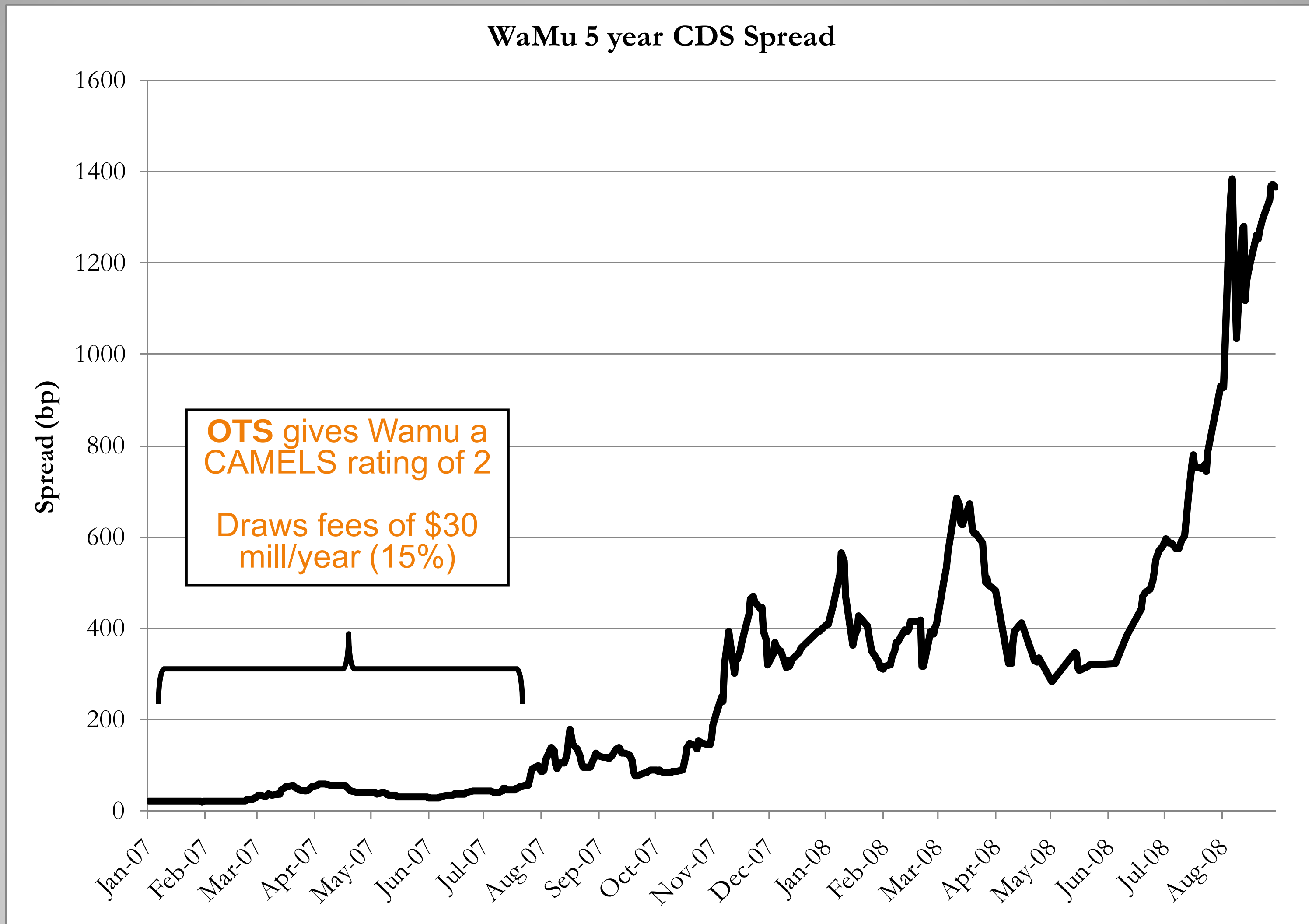
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OTS gives Wamu a CAMELS rating of 2
Draws fees of $30 mill/year (15%)
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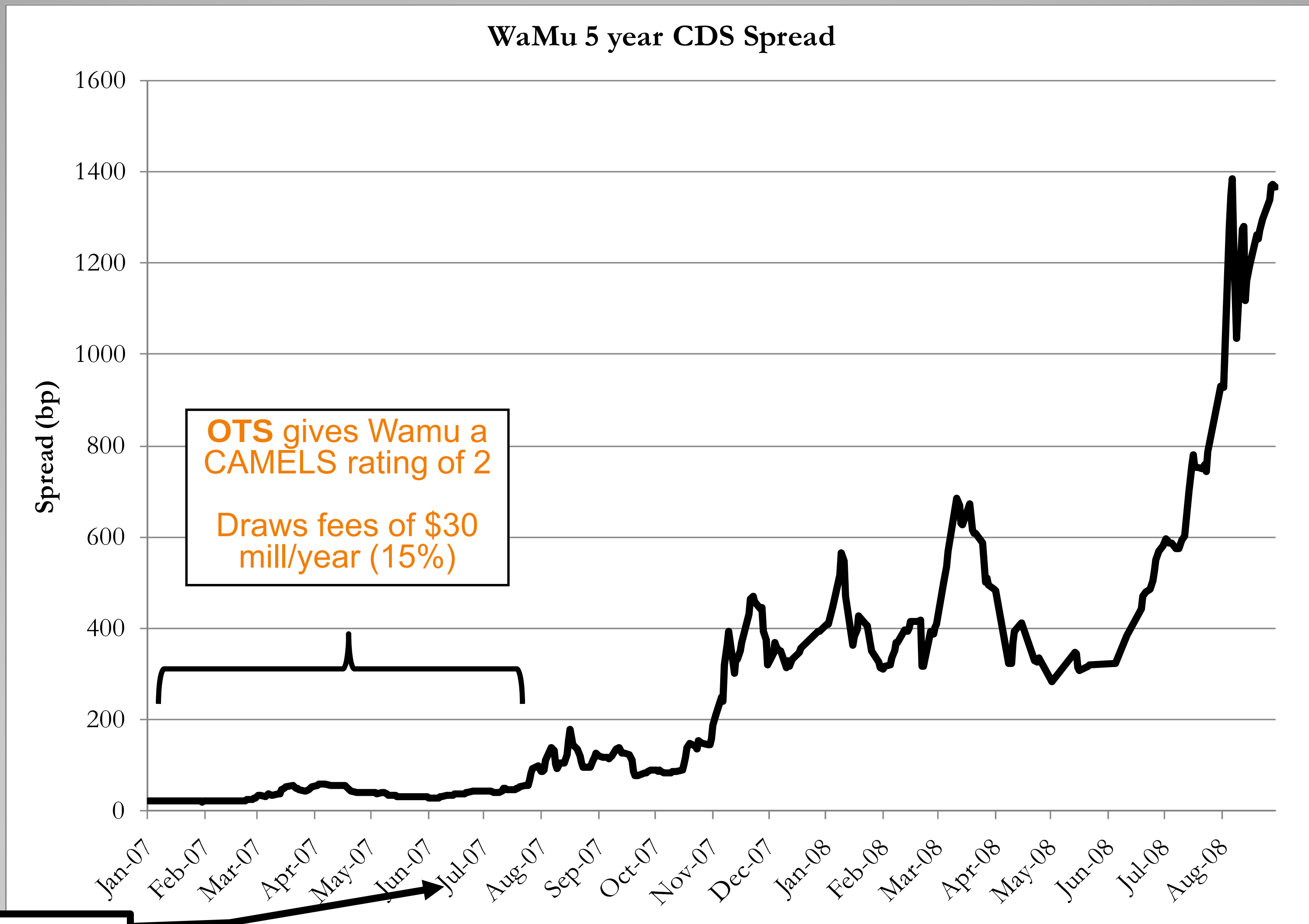
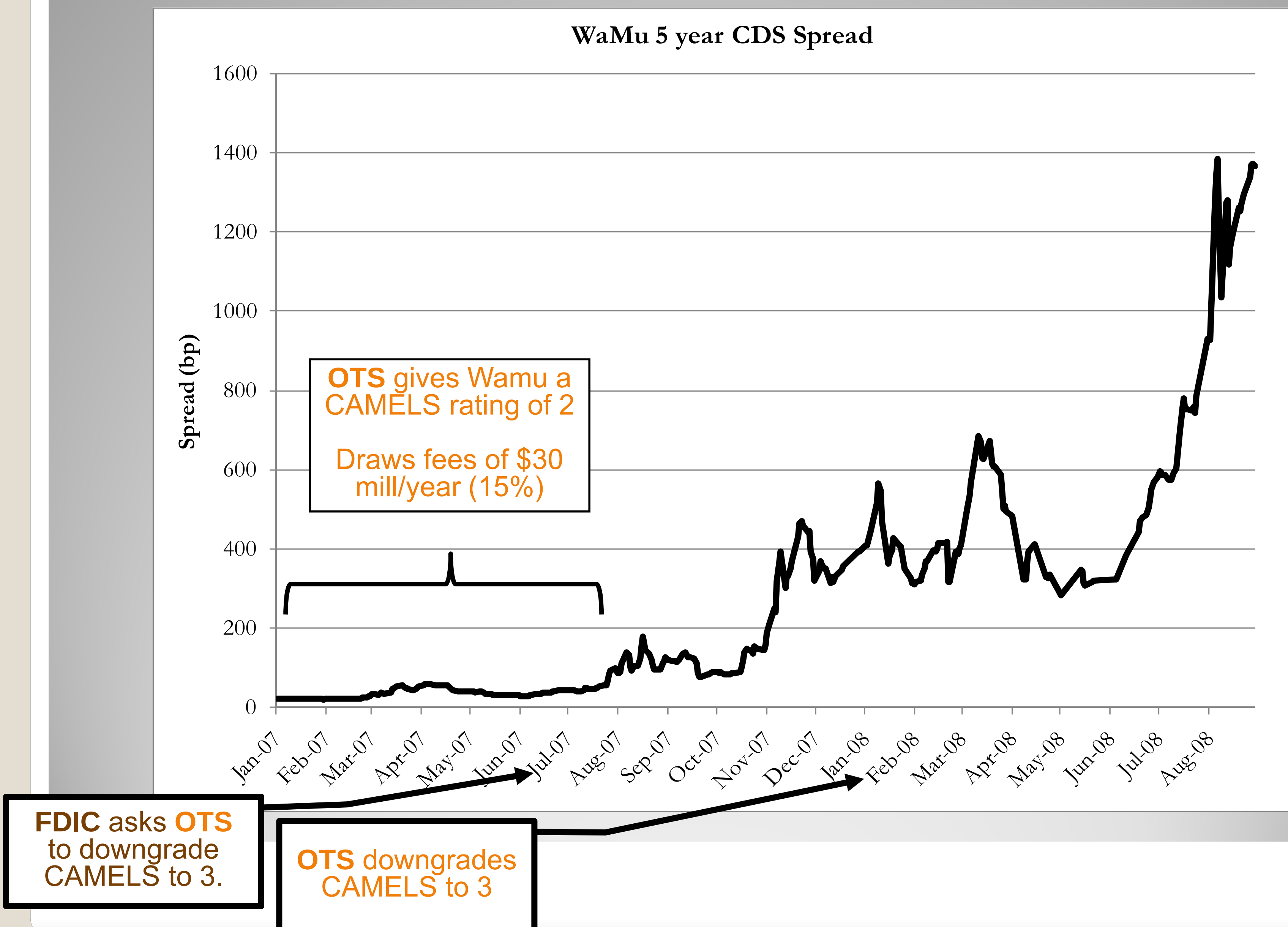


FDIC asks **OTS** to downgrade CAMELS to 3.



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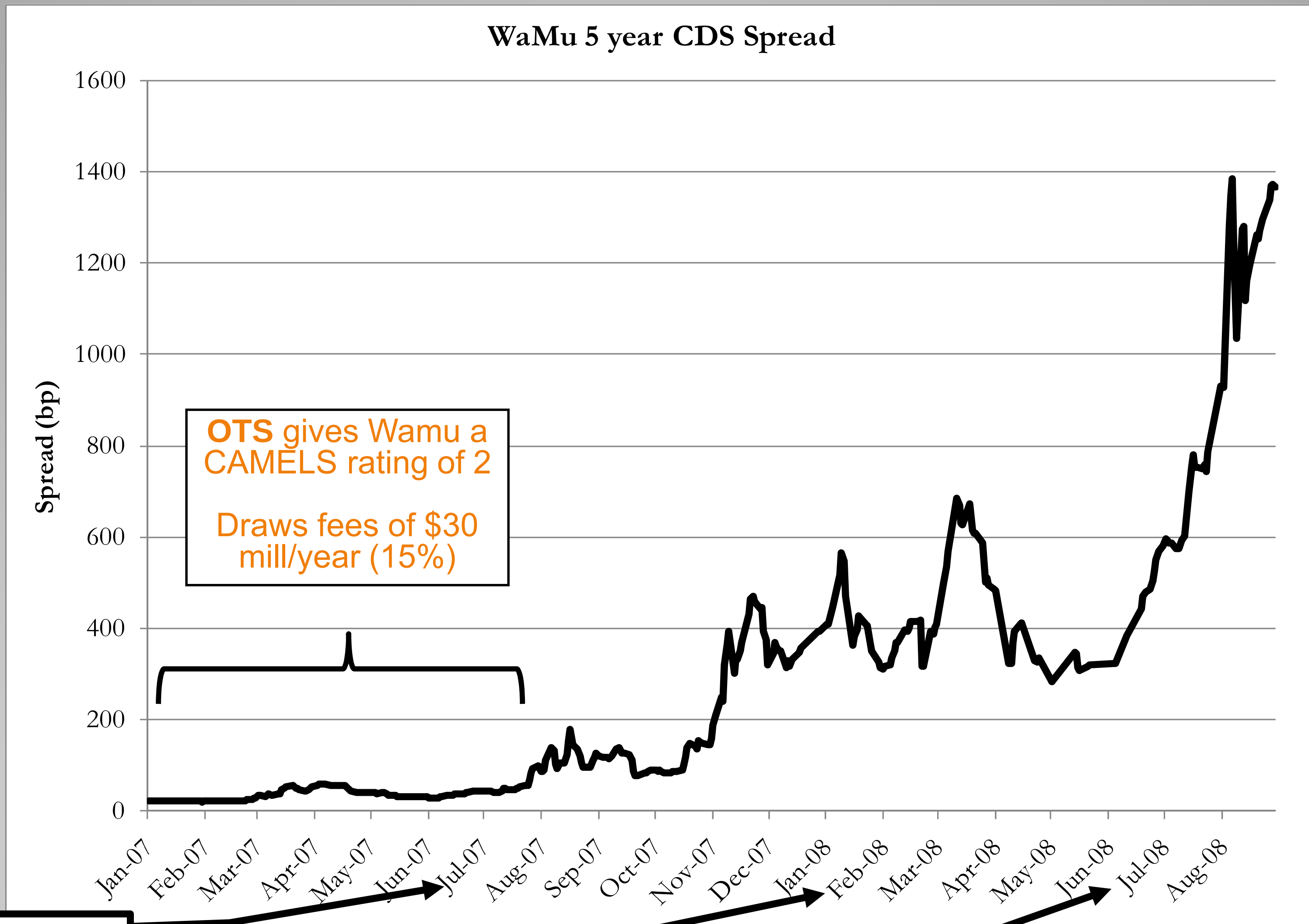

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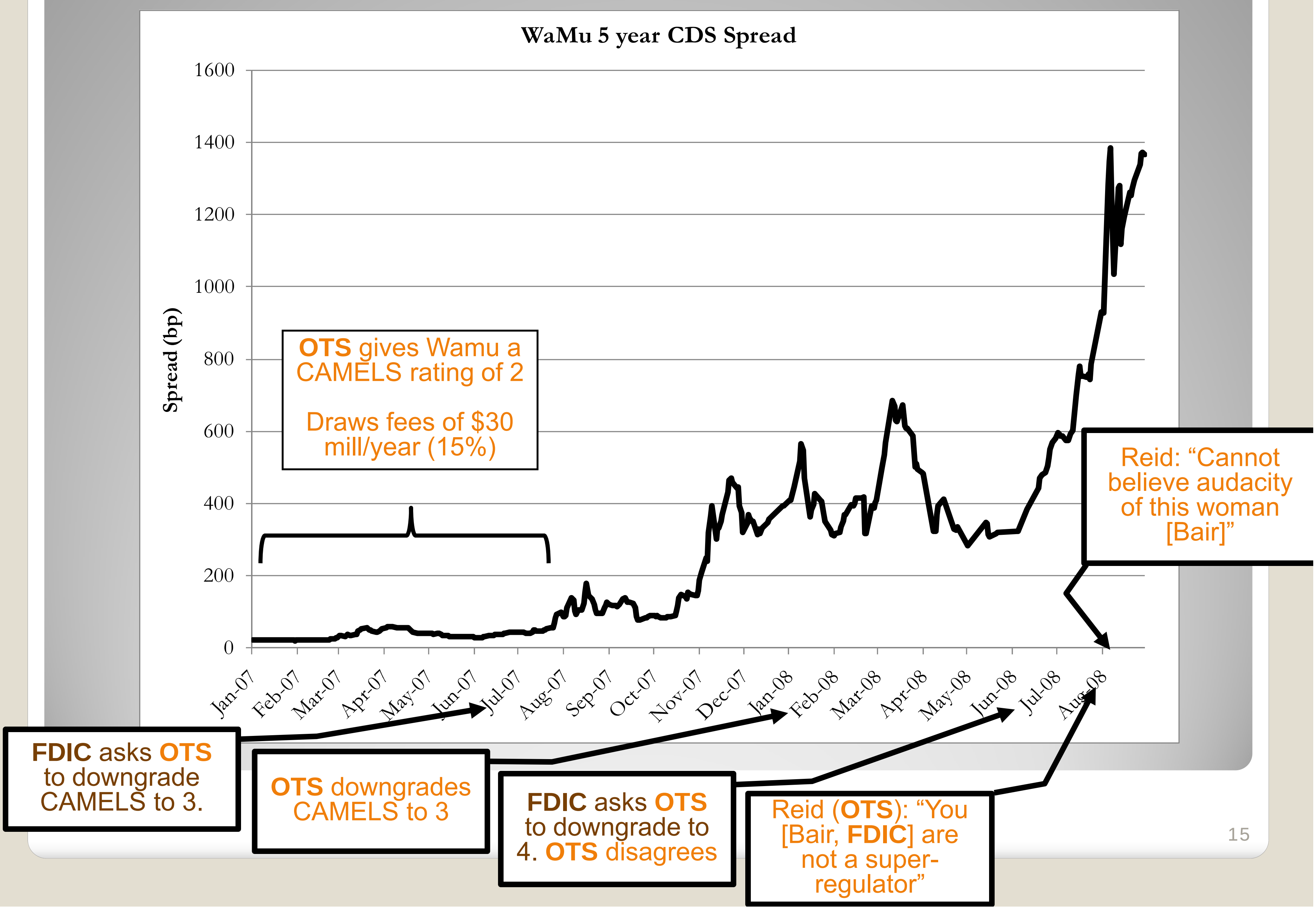
OTS downgrades CAMELS to 3

FDIC asks OTS to downgrade to 4. OTS disagrees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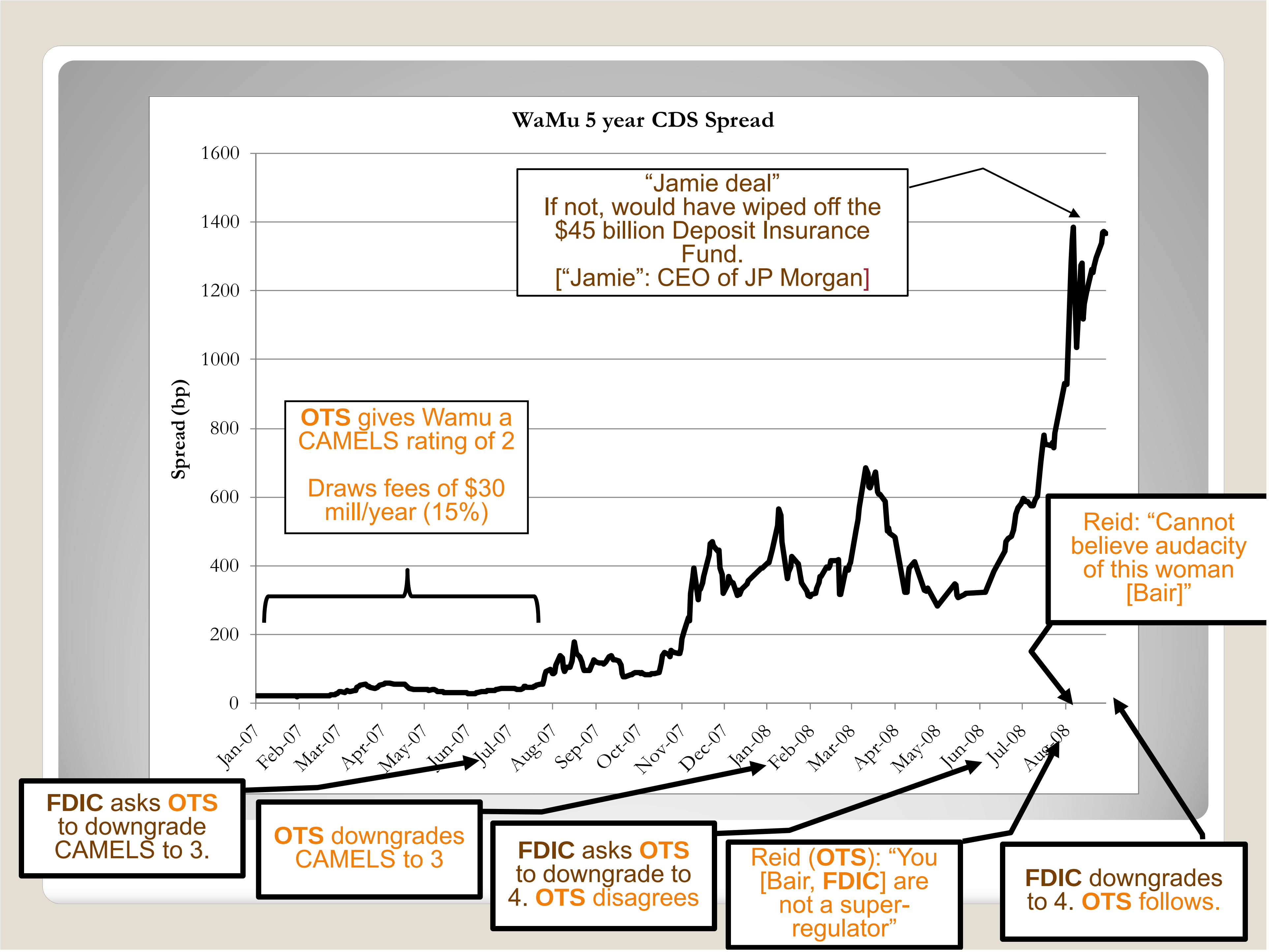

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"Jamie deal"
If not, would have wiped off the $45 billion Deposit Insurance Fund.
["Jamie": CEO of JP Morgan]
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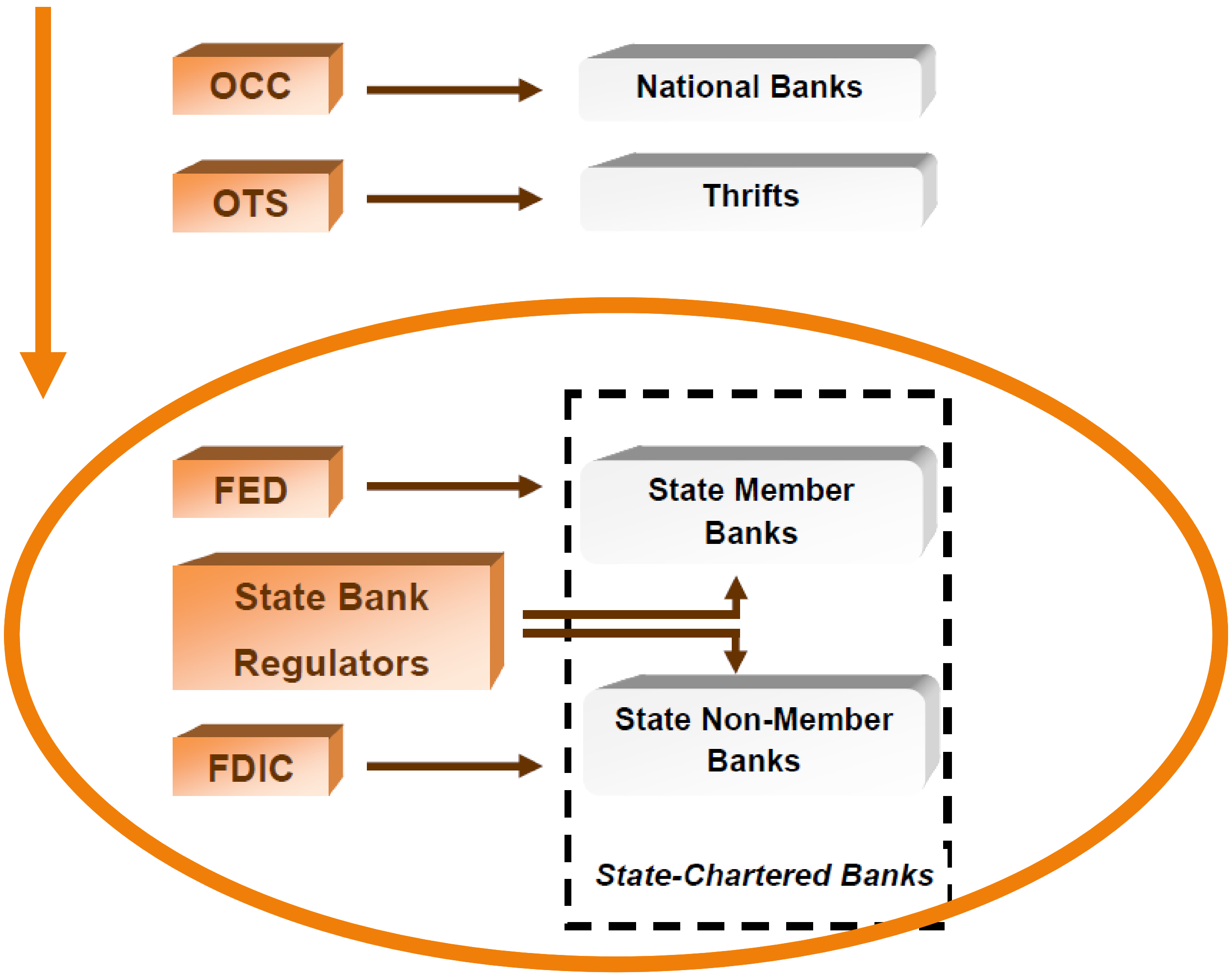
Motivation

- This is an anecdote.
- Many (scary) ones (e.g. OCC/FDIC/Citigroup – see FDIC Board of directors minutes of 11/23/08).
- Is this behavior systematic?

At least within the context of US banking, yes.

- ❑ Do different regulators implement same rules differently? Yes.
- ❑ Sizable consequences of inconsistent oversight.

Example: US State-Chartered Banks



CAMELS Upgrades/Downgrades

	CAMELS upgrade		CAMELS downgrade	
	Freq.	**Percent**	**Freq.**	**Percent**
Federal Regulator	1332	45%	3665	62%
State Regulator	1619	55%	2281	38%
Total	2951	100%	5946	100%
	Mean	**SD**	**Mean**	**SD**
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Federal regulator twice as likely to downgrade than State

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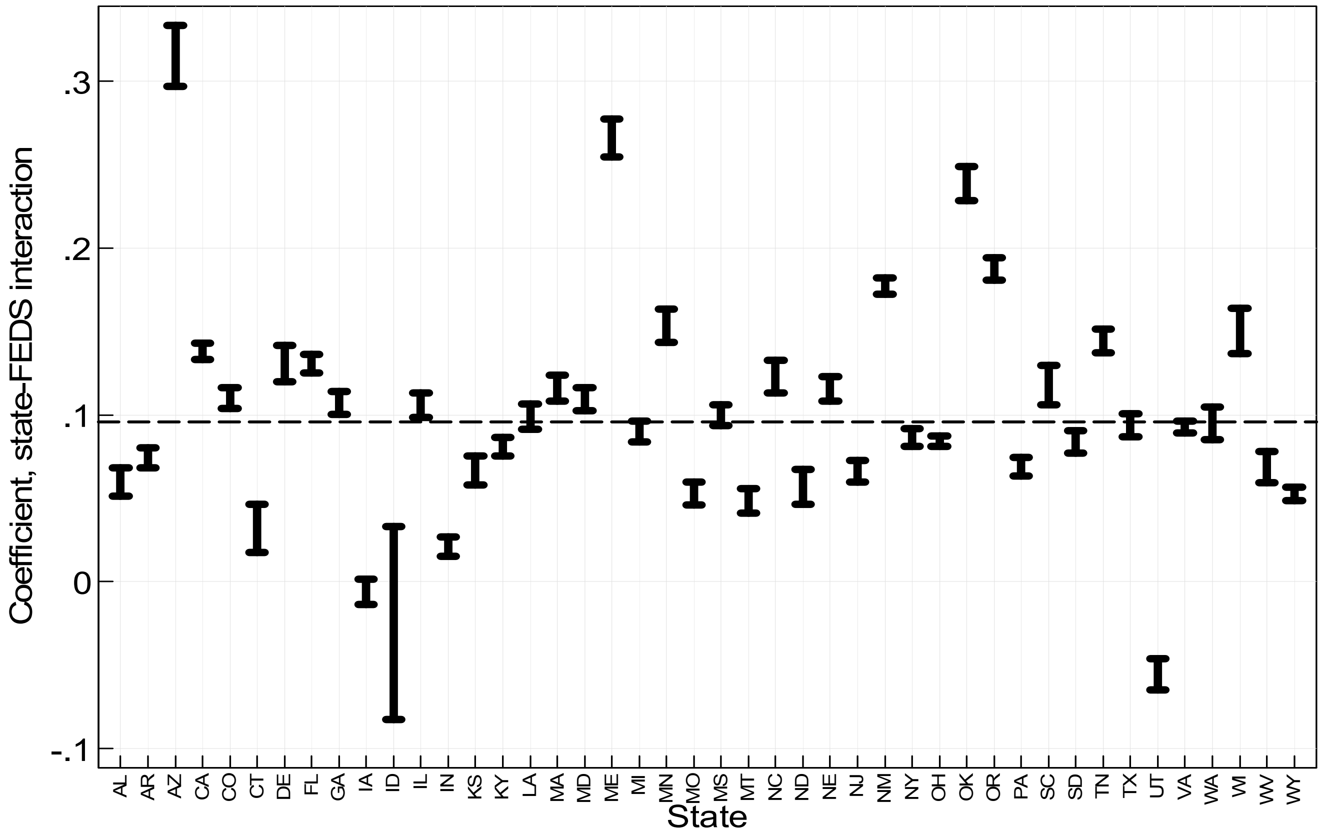
Somewhat countered by upgrades by State

Heterogeneity Across States: Regulatory "Spreads"



Additional Findings

- Banks respond to differential regulatory behavior.
  - *Federal regulators induce readjustments of*
    - *→Tier1 capital ratios,*
    - *→ Leverage,*
    - *→ NPLs & Delinquencies,*
    - *→ Implying lower ROA.*

- State-Fed regulatory “spreads” vary across states.
  - *Larger spreads correlate/predict*
    - *→ Higher frequency of bank failures,*
    - *→ More Problem banks,*
    - *→ Slower TARP repayment,*
    - *→ Costlier resolutions.*

Why do these differences exist?

- Explaining Federal/State differences (Shleifer, 1996):
  - Local regulators protect local constituents
  - Regulatory capture
  - Competence/Funding of resources:

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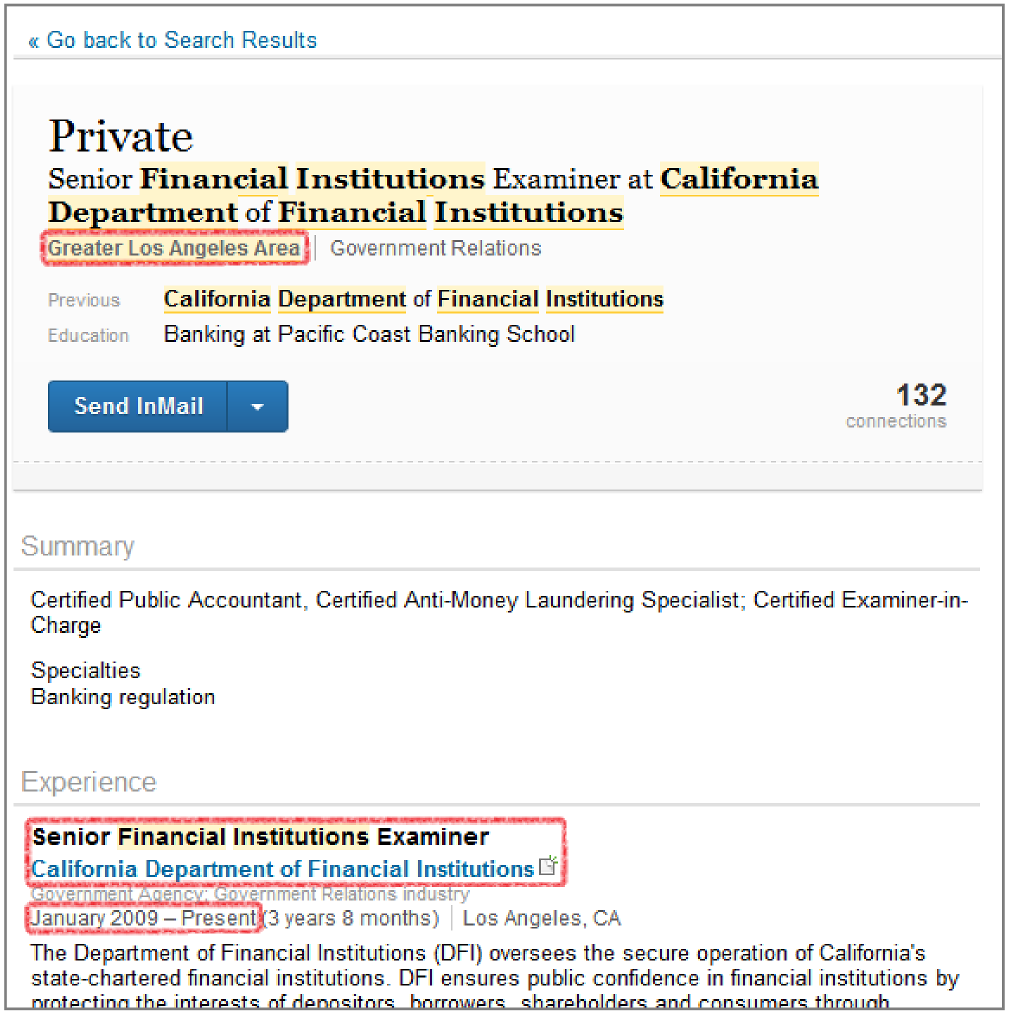
    - Limited support for “revolving door”
  - Competence/Funding of resources:

“Movement into private sector” based on LinkedIn profiles of regulators



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  - Competence/Funding of resources:
    - Higher spread in states with lower movement into private sector
    - Higher spread in states with lower training budget
    - Higher spread in states with lower # of examiners per manager

Discussion

- Lots of support for a Single Supervisory Mechanism.

- Is EU rushing into a potentially inferior regulatory architecture?

- SSM involves trade offs
  - *Will a regulatory banking union in the EU need a EU central deposit insurance + a unified bank resolution protocol for proper functioning?*

    Many say yes and that would be the closest thing to US dual system.

  - *Or is it actually better that the national supervisory agency remains somewhat exposed (residual claimant of poor banking supervision)?*

- We have close to zero empirical evidence to evaluate the trade offs involved. For sure some of these trade offs have bite in the US case.

Discussion

- Pretending we know everything about the economic forces or their magnitudes to be able to answer these questions potentially dangerous in the long run.

- At least assess heterogeneity first. How strong are the regulatory disintegration forces ECB will have to face?

  - Does the ECB have any sense of how much heterogeneity in supervisory behavior there is in the present system?

  - How is the same cross-border institution treated by different National Supervisors?