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Why did bank supervision fail?

Guido Tabellini
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The recent financial trouble has prompted much examination of private financial institutions, but few have asked why regulatory supervision did not prevent the crisis. This column argues that supervisory failure was also due to regulatory competition between national authorities and calls for a consolidated EU authority.

Guido Tabellini
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The ongoing financial turmoil is spurring a large number of reports on what went wrong and how to avoid future relapses. A clear picture of why major financial institutions made big mistakes and of systematic distortions in their incentive structures is now emerging. But on a key question there is a deafening silence: why did bank supervision fail? This is worrying, because

with hindsight it is becoming increasingly obvious that supervisory authorities too made some big mistakes. Understanding why this occurred is important, if we want to avoid future repetitions.

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A particularly comprehensive and lucid analysis of the deep causes of the ongoing crisis is contained in the Interim Report of the Financial Stability Forum presented by Governor Mario Draghi at the G7 meeting in Tokyo. The report draws attention to three specific problems (besides the poor and fraudulent practices in the US subprime market):

- Shortcomings in firms' risk management practices. In particular, too little understanding of exposure to liquidity and market risk.
- Poor due diligence practices, including excessive and misplaced reliance of credit rating agencies.
- Imperfect public disclosure of the links between on and off balance sheet items.

Of course, these are only proximate causes, and the report asks: "Why did financial institutions make these major mistakes?" The answer given is twofold. On the one hand, poor judgement was almost certainly involved. The rapid pace of financial innovation meant that even sophisticated investors did not always fully understand the risk properties of the complex structures that were built. The systemic implications of these financial arrangements were even more poorly understood. Probably, although the report does not say this, investors were fooled into collectively overestimating the resilience of global financial markets.

On the other hand, there were systematic incentive distortions. First, the "originate and distribute" model entails obvious moral hazard problems. Second, credit rating agencies face a conflict of interest. Third, management compensation schemes reward myopic risk taking behaviour; it is rational for me to under-insure against the occurrence of rare disruptive events, if my bonus only depends on short-term performance indicators.

All this is good and sound – and far from trivial. But it is only part of the story. The other part is that banking supervision did not prevent these shortcomings from occurring. Each one of the proximate causes listed above could have been prevented or at least discouraged by better and more proactive financial supervision. Supervisory authorities did not discourage the build up of off-balance sheet risk exposure, although it was often induced by regulatory arbitrage. They did not seem to care about, or they simply ignored, the implicit contingent liabilities that this entailed for banks'

balance sheets. The relevance of liquidity and market risk (as opposed to default risk) was neglected.

Insuring adequate risk management of modern complex financial institutions is a joint responsibility of the management of such institutions and of the supervisory authorities. If risk management proves inadequate, it is a joint failure, not just a management failure. Asking why supervision failed is just as relevant as asking what went wrong inside the private financial institutions.

Why did supervision fail?

Two answers can be given. The first one is bureaucratic inertia together with poor judgement. Just as it happened with sophisticated investors, the rapid pace of financial innovation may have led astray well-intentioned supervisory authorities. Everyone, from the top banker to the last employee of government bureaucracies, did not fully understand the huge risks that were piling up in these complex financial structures. Moreover, while bank regulators and supervisors are traditionally worried about capital adequacy ratios, they were just too slow to adapt their priorities and practice to the new dangers: lack of liquidity and market risk. They were also unlucky, because the financial turmoil hit them right in the transition between Basel I and Basel II. We cannot rule out that in a year or so financial supervision would have been in a position to identify and remedy the weak points in the system. Finally, light supervision might also have reflected excessive confidence in the self-regulating abilities of modern financial institutions and an ideological conviction that over-regulation was the more relevant danger to be avoided.

This explanation of why supervision failed is plausible and likely to contain important elements of truth. But it is incomplete. Much information was actually available, and there were mounting signs of concerns of too much complacency, both by individual investors and by public officials. Yet the information was not acted upon. This suggests that other forces were at work.

The second possible answer is distorted incentives. Bureaucratic organizations respond to incentives, just like financial institutions and their top managers. The main suspect here is regulatory competition. Imposing sound risk management procedures raises costs. It is quite likely that the lax supervisory standards and practice also reflected the concern that the domestic industry would be hurt relative to foreign based competitors or the fear that some institutions would shift part of their business to regulatory heavens.

What can be done to remedy these incentive problems and achieve an effective international coordination of banking supervision? To some extent, the answer can only be provided by the supervisory authorities themselves, with reference to specific and concrete details. But whatever is done, it will not completely solve the problem. The Basel frameworks have been designed to prevent this kind of harmful regulatory competition. But while Basel I is based on hard numbers, the more flexible supervision under Basel II can be implemented with different degrees of stringency at the authorities' discretion. This means that the distortions caused by regulatory competition will not go away. It is not enough to agree that supervisors need to encourage better risk management practice and the build up of adequate liquidity buffers. One also needs to worry about whether national supervisors acting unilaterally will have the resolve and incentives to take effective actions. If their incentives were too weak just before this crisis, they will remain weak once this storm is gone.

The need for EU supervision

Worldwide coordination of bank supervision can only be achieved through informal means. But Europe can be much more ambitious. It is time to think about replacing national regulation and supervision of banks with an EU-level agency. Besides the issue of regulatory competition, there are additional and important arguments in favour of an EU-level supervisory authority. It is almost self-evident that cross border banking requires some form of trans-national or super-national supervisory entity. Moreover, while local knowledge may be important, modern financial arrangements have become so complex that there are relevant economies of scale in concentrating the needed expertise inside a single supervisory agency.

One should always be wary of taking rushed decisions during a crisis, because the likelihood of making mistakes is very high. But the case in favour of a EU-wide regulatory and supervisory regime for banks is overwhelming. The crisis and the failure of national supervisory agencies provide a unique opportunity to overcome bureaucratic and political opposition to this institutional innovation.

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