Theory and Practice of Supervision

Comments by Mark Flannery

"Supervising Large, Complex Financial Institutions: Defining Objectives and Measuring Effectiveness"

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Why Intervene?

Market failure; externality

1. "Systemic" costs of a large bank's failure
2. Deposit insurance (Dewatripont and Tirole)
3. Shareholders' ex post incentive to raise PD more than uninsured liability holders expected.
4. Crowded trades
5. Governance failure w.r.t. risk management?

Goal of Intervention

- Minimize {PD * LGD} for large financial institutions

- Post-crisis regulations have addressed PD
  - more (book valued) capital
  - stress testing
  - activity limits (Volcker, liquidity transformation)
  - compensation practices (Fed's guidance, 2010)
  - central clearing of OTC derivatives
  - Basel IV
- Less discussion in these two papers of efforts to reduce LGD: Title II Orderly Resolution (or Chapter 14?)

How does supervision relate to regulation?

- Regulation relies on <u>verifiable</u> aspects of bank operations
  - Engage in prohibited activities?
  - Discriminatory behaviors?
  - Sufficiently liquid assets?
  - Adequate capital?
  - “Books and records”
  - NEW: limits on bilateral exposures.
- Supervision deals with collection and evaluation of <u>soft information</u>
  - Monitoring: what’s going on?
  - MRA/MRIA: what can be done about it?
  - “Non-verifiable” ➔ interpretation depends importantly on supervisors’ assessment of implications
- Hirtle paper: valuable information for understanding supervision

“Economics of Supervision” Model

- Very imaginative. Structure helps a lot.
- Data work creative.
- What does an MRA accomplish? Enhanced risk management.
  - The model assumes that A, D, E are verifiable.
  - Monitoring generates a signal of asset return volatility (s_1), which may elicit a supervisory action (s_2) that enhances risk management.
  - Reduces the variance of portfolio returns
  - Complements bank’s own chosen effort

- Equivalent to having supervisor influence PD, conditional on exogenously chosen asset portfolio.

What else can monitoring do? (1)

- I don’t think the set of verifiable facts is so large as the model assumes.

- A can be mis-represented
  - Optimistic loss forecasts
  - Optimistic fair valuations
  - Optimistic computations of risk weights

- Monitoring has more to do than just risk management.

What else can monitoring do? (2)

- Monitoring involves learning the bank's business
- Generates information about the best re-organization, as in TLAC.
- Two questions, then:

1. Is information from the supervisory monitors available to the FDIC staff who will administer Title II?
2. Are assessments of living wills integrated into the supervisory process?

“Discomfort”

- The cost of supervision “could include, for example, the non-monetary discomfort experienced by the supervisor when imposing intervention measures that a bank disagrees with.” (page 18)

- Supervisors will always have incomplete information.
- Supervisors will sometimes need to take prompt, expensive actions that the bank resists.
- How does a supervisory team decide to pull the trigger?
- What legal tools can the bank use to delay implementation?

Accounting

- Lesson from crisis: when things start to go badly, book values adjust
  - Slowly
  - Subject to managerial beliefs
  - Strategically (?)
- More things are now fair-valued
- Capital adequacy regulations are expressed in terms of measures that can be influenced by management.
- Could supervisors possibly “win” with regulations defined in “book” terms?

Combine “discomfort” with accounting questions

- Market assessments can take off some of the pressure to delay.
- Create some role for market valuations in supervision.
  - Forward looking
  - Reflects more than just supervisory opinions
  - Not personal
- Like any other signal, there will be errors.

Limiting permissible bank activities

- In the model, portfolio is exogenous and risk management applies to the overall (average) portfolio return.
- Could think of product-specific s_1 and s_2, and ask whether some activities have too large a cost of generating a high λ.

$$\Pr(\bar{r} \mid \bar{a}) = \Pr(\underline{r} \mid \underline{a}) \equiv s_1 = \lambda$$

- Such activities effectively cannot be supervised, and should not be permitted in an institution whose weakness can have external effects.
- Supervisory technology thereby influences regulation.

Crowded trades

- Horizontal reviews
  - Shared exposures
  - Best practices

- Identify shared (potentially systemic) exposures

Summary

1. Zero failure is not a goal, but low PD*LGD should be.
2. Accounting-based standards can undermine capital adequacy regulations.
3. Monitoring should be heavily involved in assessing fair values.
4. Expand the second paper's model to consider product-level monitoring and implications for permissible activities.
5. MRAs and MRIAs should be at least partly based on market valuations. E.g. for capital adequacy purposes.
6. "Understanding the business" through monitoring should help administer TLAC and Title II, to minimize losses associated with bad outcomes for large banks.