Supervisory Incentives in a Banking Union*

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Outline

The creation of a banking union in Europe constitutes an important change in the institutional design of banking supervision. As of November 2014, the Single Supervisory Mechanism (SSM), which will reside within the European Central Bank, will be the primary supervisor of the Eurozone's biggest banks. It will supervise directly the largest 128 banks in the Eurozone, accounting for approximately 85% of the banking assets in the Eurozone, and indirectly all the banks in the Eurozone. This new supervisory architecture raises important questions concerning the cooperation and the dialectics between the national supervisors and the SSM, and the decision making process of the new system.

This paper studies how a supervisory agency's institutional design affects its incentives to collect information. The model is inspired by the new Eurozone's banking union project. A supranational agency has legal power over all decisions regarding banks, but has to rely on local supervisors to collect the information necessary to act. Local supervisors have some degree of freedom on information collection, but are mandated to transmit to the central agency what they learn. Critically, local supervisors have utility functions that are different (perhaps just slightly) from that of the central agency. This generates a principal-agent problem (in addition to that between supervisors and banks) that is at the core of the model in this paper. Our idea is that information collection will be "inferior" to what would happen in a model with fully independent supervisors or one where the centralized agency directly collects information. The reason is that local agents will, in some states of the world, prefer to remain ignorant

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rather than to potentially learn information that would lead the central supervisor to decisions that are against the local agents' interests. This has costs. The problem for the central agency is obvious. But the lack of information can also lead to results that are undesirable for local supervisors, and may lead to inefficient outcomes in terms of bank resolution. This, in turn, this will lead to poorer ex ante incentives for regulated banks.

Once this main result is established, the paper will delve into what factors make the conflict more or less relevant and what policies the central supervisor can enact to correct it. The starting point of the analysis is that the local and the central supervisors have different utility functions and, consequently, can take different decisions. As a first approximation: there are some states of the world for which the local supervisor would allow certain banks to operate while the central agency would intervene and resolve them. This stems from two main forces: 1) Banks may be systemic at the national but not the supranational level; 2) Local supervisors internalize the cost of resolution (which remain nationally borne) more than the centralized agency.

Based on this setup we would expect the conflict to be greater for:

1) Regional banks that are systemic for individual countries but not for the Eurozone as a whole

2) Local supervisors in fiscally weak countries that are hence more reluctant to bear the cost of resolution

3) Concentration: in small countries, a more concentrated banking system increases the probability of having locally systemic but not globally systemic banks. In large countries, this may not be true.

The baseline model will then be extended in various directions. First, we will introduce reputation concerns for the local supervisor and analyze the extent to which they can help ameliorate the insufficient information acquisition problem highlighted in the baseline model. Second, we will analyze in more detail the incentives for the central supervisor to collect information on the banks under its supervision directly rather than having to rely on the information produced by the local supervisor.