Session on Governance of the Regulatory Decision Making Process

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Suggested topics for discussion

- Is the Basel II process driven by the interests of G-10 countries?
- Is the Basel Committee “captured” by the largest banks?
- Do smaller banks or smaller countries have “sufficient” input?
- Are these concerns important?

Paper 1

Oliver Baete (McKinsey & Company)

"Understanding Basel II Operational and Strategic Implications"

Paper 2

Richard Herring (University of Pennsylvania)

"Structure and Organization of Cross-Sector Financial Supervision"

Discussion on Baete

Issue: What are the “side effects” of Basel II?

- Improved risk management
- Better risk pricing → end of cross-subsidization
- Substantial new regulatory arbitrage (SA / F-IRB / A-IRB)
- Further consolidation in retail sector
- Impact on systemic risk?

Discussion on Baete

Question

- Why (most) banks waited for the regulator to move?
- Why was the profit motive not enough?

Discussion on Baete

Key result: Basel II implies steeper loan pricing curve

→ Reference: Repullo and Suarez, *JFI* 2004

→ Loan pricing equation (under perfect competition)

$$(1-PD)\times r - PD\times LGD - c\times k = 0$$

$$\downarrow$$

$$r = \frac{PD\times LGD - c\times k}{1-PD} = f(PD, LGD, c, k(PD))$$

Discussion on Baete

Proposition 3 (Repullo and Suarez, 2004)

• Loan rates of low risk loans determined by IRB capital charges

• Loan rates of high risk loans determined by SA capital charges

→ Concentration of credit risk in smaller SA banks

Discussion on Baete

Prediction: Wave of consolidation in retail banking

- Growing importance of economies of scale
- Credit losses hitting small banks

  → Lower capabilities to assess and price risks

Discussion on Baete

Comment 1

- Small SA banks will have comparative advantage

  → lower regulatory capital (in relation to IRB banks)

- Profitability in retail banking need not decrease

  → fewer competitors

Discussion on Baete

Comment 2

• Small SA banks will have riskier portfolios

→ but they will have higher margins to cover losses

→ need not have “lower risk taking capacity”

Discussion on Baete

Final comment

- Small SA banks can specialize in (types of) relationship lending

  → and be able to do very well

Discussion on Herring

Issues

- What will be the future structure of financial supervision?
- Will an integrated supervisor (IS) model emerge?

Discussion on Herring

Pros of IS model

- Efficiency in oversight and compliance
- Level playing field

Cons of IS model

- Conflicts of interest

  → conduct of business vs micro/macro prudential

- Concentration of (supervisory) power → less innovation

Discussion on Herring

Conclusions

- Alternative models appear to work in normal times

  → IS model not tested in crisis

- Organization of supervision matters less than

  → Quality of supervisory staff

  → Independence (political and financial)

- Rationale for supervisory role of central banks

  → Especially compelling in emerging markets

Discussion on Herring

Comment 1

- Is there an "optimal" structure of supervision?

  → Probably not

  → Depends on how different objectives are traded-off

  → Political choice

Discussion on Herring

Comment 2

- Should more research be done on this topic?

  → Yes!

  → Too important to rely on intuitions / fashions / prejudices

- Idea: Changes should move system in the "right" direction

Discussion on Herring

Comment 3

- Many moves towards IS model explained by failures not in the structure of the traditional model, but in its implementation, e.g.

  → on-site versus off site examinations

  → statutory versus self-regulation, etc.

Discussion on Herring

Final comment

- Is there a general guiding principle?

  $\rightarrow$ Yes!

  $\rightarrow$ **IIABDFI**

Discussion on Herring

Final comment

- Is there a general guiding principle?

  → Yes!

  → **I**f **I**t **A**in't **B**roke **D**on't **F**ix **I**t