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The economic crisis: Did supervision architecture and governance matter?☆

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ABSTRACT

Since the mid-1990s worldwide efforts were undertaken to improve the effectiveness of financial supervision, through modifications in the architecture and governance. Did these improvements mitigate the 2008–2009 Crisis? This paper brings the first systematic analysis of the role of three main efforts: consolidation in supervision, decreasing central bank involvement and improving supervisory governance. The analysis employs a new and complex database on supervisory architecture and governance for 102 countries and uses two new indicators to evaluate the supervisory regime: the Financial Supervision Herfindahl Hirschman (FSHH) and the Central Bank Supervisor Share (CBSS) Indexes. The empirical tests allow us to disentangle the relative effects of the supervisory regimes on macroeconomic resilience. We conclude that two supervisory features—supervisory consolidation and supervisory governance—were negatively correlated with resilience, while central bank involvement in supervision did not have any significant impact. Our results show that the conditions under which micro-features of the supervisory design produce automatically macro-optimal outcomes are far from identified, and consequently contradict what was the generally accepted view before the crisis.

1. Introduction

In the aftermath of the Asian financial crisis, international financial institutions (IFI), national stakeholders and academia devoted a great deal of energy at improving the quality of the regulatory and supervisory framework for finance. It was hoped that more effective regulatory and supervisory frameworks would help to avoid, or at least mitigate the effects of, a possible next crisis. The effectiveness of the regulatory and supervisory settings was based on their micro capacity to design and implement the correct interest alignment in all the players involved in the banking and financial industry.

Emerging initiatives, such as the Basel Core Principles for Effective Bank Supervision (BCP), were reinforced and new initiatives, such as the IMF-World Bank Financial Sector Assessment Programs (FSAP), were implemented. In the same period, work on the Basel II regulatory framework saw the light of day. These international efforts were complemented by revisions, by several national authorities, of their supervisory architecture in order to enhance the effectiveness of supervision. This wave of revisions was characterized by two intertwined trends (Masciandaro and Quintyn, 2009): consolidation and specialization, which produced less central bank involvement in supervision. Crisis mitigation brought additional arguments to the table for revising the national supervisory architecture. In parallel, work was also undertaken to strengthen governance of supervisory agencies.

There was increasing hope that these improvements would mitigate the impact of any possible future financial crisis. The idea was based on the theory that, if micro incentives were correctly aligned, the macro outcomes would be automatically positive—Micro to Macro Approach, or M t M, notwithstanding the fact that the empirical evidence in this respect was mixed.

The financial and economic mess—the Crisis—that started in 2008 destroyed hopes. Supervisory failure was mentioned by several scholars and policymakers as one of the main contributing

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factors, besides macroeconomic factors, regulatory failures, and failures in other parts of the governance of the financial system.

The objective of this paper is to test empirically the impact on the resilience of the economy to the Crisis of two types of efforts at strengthening supervision that were high on many countries' agendas: changes in their supervisory architecture essentially in the direction of both unification and less central bank involvement; modifications in supervisory governance toward more independence and accountability. We limit ourselves to these two main aspects of supervision because research on their role as drivers of the Crisis has not been undertaken so far in a systematic way.

The main empirical findings can be summarized as follows: (i) two types of modifications introduced in supervision (unification and effective governance arrangements) are negatively associated with economic resilience; (ii) the degree of involvement of the central bank in supervision did not have any significant impact on resilience; and finally (iii) we also find that the quality of public sector governance and the degree of financial liberalization are negatively associated with economic resilience in this Crisis. In fact, these associations are even stronger than those of the supervisory features that we analyze.

The paper is structured as follows. Section 2 sets out the conceptual framework and reviews the related literature. Section 3 presents the empirical evidence of the impact of supervisory architecture and governance on financial and economic resilience. Section 4 concludes.

2. Background and conceptual framework

Since the mid-1990s, international financial institutions (BIS, IMF, World Bank), academics and national authorities have started to pay attention to the quality of supervision, as a complement to the long-standing interest in financial regulation.

The specific role of supervision in contributing to the overall macro performances emerged as part of the general micro founded approach to financial regulation, which is based on the relationship between optimal individual risk assumption, regulatory framework and macroeconomic outcomes.

Before the Crisis the key assumption was that regulations which make individual agents sound and safe also make the overall system safe and sound (see among others Goodhart et al., 1998; Brunnemeier et al., 2010). The "Micro to Macro" (M t M) approach can be summarizes as follows.

At the individual level, it is reasonable to assume that the capacity to produce and exchange resources depends on the personal willingness to take risks. Consequently, the choices that are made to produce and exchange goods and services will be more frequent the higher the certainties about the context in which individuals are acting are. Therefore the crucial cornerstone becomes the relationship between risk-taking and certainty.

This is where the role of regulation as a pass-through vehicle from individual choices to macro outcomes comes in. The more the system of rules produces a certainty-generating environment, the higher will be the propensity to undertake risks, the higher will be the aggregate growth. A virtuous, dynamic and automatic relation between rules and growth has been identified.

Stable growth was associated with higher certainty, which in turn depended on regulation itself and was a part of a more effective system of public governance (see for example Kaufmann et al., 2008). The macro relation between stable growth and well-designed rules was supported by theory and empirical research (see for example Acemoglu et al., 2005). The quality of regulation as relevant factor for stable growth was particularly emphasized in the case of financial rule-making (Barth et al., 2004; Levine, 2005a,b). In this theoretical framework supervision—i.e. the implementation, monitoring and enforcement of the regulatory framework—plays an important role.

For the purpose of this paper we focus on the two areas that received the greater deal of attention: revisions of the supervisory architecture—mainly in the direction of unification of supervisory agencies—and improvements in supervisory governance. Before focusing exclusively on these two, it is useful to put them in the broader context of all initiatives that were taken to improve the effectiveness of supervision. We divide them into four groupings.

As a first initiative, the Basel Core Principles for Effective Banking Supervision (BCP) were issued in 1996 (Basel Committee, 1996), more or less at the eve of the Asian financial crisis. The objective of the BCPs was to promote best practices in the content of the regulatory framework, as well as in bank supervision. The BCPs were complemented a few years later by similar codes for the supervision of securities operations (IOSCO) and insurance supervision (IAIS). Work on the BCPs intensified greatly in response to the Asian crisis. This crisis had indeed brought to the surface a number of major flaws in the supervisory process (see Lindgren et al., 1999), in addition to regulatory flaws. Thus, the BCPs were used for peer reviews as part of the FSAPs jointly conducted by IMF and World Bank. The principles themselves were subject to a major revision in 2006.

A second development was the search by national authorities for the architecture that would make supervision as effective as possible. Although it was evident from the start that the supervisory architecture was generally considered as a second order issue, and that the quality of regulation and supervision were of predominant importance, a great deal of attention went to the architecture.

Unifying all sector supervisors under one roof was increasingly considered the most effective solution, given the blurring of demarcation lines between several types of financial institutions and the formation of all-encompassing financial conglomerates (Abrams and Taylor, 2002; Llewellyn, 2006). While the Scandinavian countries were the forerunners in the early 1990s, the real start of the "reform hype" came with the establishment of the FSA in UK in 1997. Since then, many countries have reformed their supervisory architecture. However not all countries opted for complete unification, but configurations with different levels of integration in supervision emerged with a changing role for the central banks in the supervisory process (for an overview, see Masciandaro and Quintyn, 2009).

In an effort to distinguish trends in the new supervisory landscape, Masciandaro and Quintyn (2009) came to the conclusion that before the Crisis the trend in the changes in supervisory structures were characterized by two intertwined features: consolidation (or unification) of supervision goes hand in hand with the specialization of the central bank in pursuing its monetary policy mandate, and vice versa: even in presence of several regulating authorities, the central bank was likely to be still deeply involved in supervision.

A third type of development concentrated on the need for principles of effective supervisory governance in order to withstand various sources of captures (political, industry and self-capture) that supervisors are facing. Das and Quintyn (2002) and Quintyn (2007) proposed a governance framework consisting of four reinforcing pillars (independence, accountability, transparency and integrity) while Rochet (2004) used a theoretical model to argue in favor of establishing independent and accountable banking supervisors. Additional work on supervisory independence (Quintyn and Taylor, 2003) and accountability (Hüpkes et al., 2005) spelled out necessary operational components of these governance pillars. Ponce (2010) developed a theoretical model showing that supervisory independence had a positive impact on financial