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Divide et impera: Financial supervision unification and central bank fragmentation effect

Donato Masciandaro *

Paolo Baffi Centre, Bocconi University, via Sarfatti 25, 20136 Milan, Italy

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Abstract

This paper analyses how the role of the central bank can influence the unification of the overall financial supervision architecture. We claim that the policymaker's choices can be viewed as a sequential process in which the institutional *status quo* matters. The degree of unification in supervision is decided based on the position of the central bank. If the central bank involvement in supervision and its reputation are high, the unification level is likely to be low, and vice versa. The central bank fragmentation effect can be explained through the three possible channels of moral hazard, bureaucracy, and reputation endowment effects. The empirical analysis–performed with ordered logit and probit functions on a dataset of 89 countries–confirms the robustness of the central bank fragmentation effect.

JEL classification: E58; G18; G28
Keywords: Financial supervision; Central bank; Unified supervision; Path dependence

1. Introduction

Financial supervision regimes vary significantly from country to country. A review of the supervision architectures[1] indicates a trend toward a gradual concentration of powers. In Europe this trend has seemed rather strong in recent years. In addition to Norway, the first country to establish a single supervisor in 1986, and Iceland (1988), six other European Union member states–Austria (2002), Belgium (2004), Denmark (1988), Germany (2002), Sweden (1991) and

* Tel.: +39 02 58365310; fax: +39 02 58365314.
E-mail address: donato.masciandaro@unibocconi.it.
[1] The review is performed in Section 3.

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the United Kingdom (1997)–have assigned the task of supervising the entire financial system to a single authority other than the central bank. In Ireland (2003), the supervisory responsibilities were concentrated in the hands of the central bank. Four countries involved in the 2004 EU enlargement process–Estonia (1999), Latvia (1998), Malta (2002) and Hungary (2000)–have also reformed their structures, concentrating all powers in a single authority,[2] while, outside Europe, a unified agency has been established in Kazakhstan (2004), Korea (1997), Japan (2001), Nicaragua (1999) and, among the small countries, in Bahrain, Bermuda, Cayman Islands, Gibraltar, Maldives, Netherlands Antilles, Singapore and the United Arab Emirates.

The single supervisor regime seems to be the "natural" and best answer to the challenges posed by financial market integration. If, in the long run, the expected financial structure is a perfectly integrated and single market, the best design for the supervisory architecture would seem to be the single authority. But the answer is apparently not that simple.

The descriptive evidence[3] seems to correct the idea that, given the blurring process in the financial landscape, there are two possible approaches to supervision: 1) unification under the roof of the central bank; and 2) unification in a different supervisory body.[4] In reality, the unification of supervision seems evident only in the case of a single financial authority. In other words, the descriptive analysis signals an interesting result: the national choices on how many agencies are to be involved in supervision is strictly linked to the role of the central bank. The degree of supervision unification appears to be inversely related to central bank involvement. The trade-off is confirmed by exploring the determinants of recent reforms in supervisory regimes.[5]

How do we explain the fragmentation effect caused by the involvement of the central bank in supervision? The aim of this paper is to shed light on the economics of the central bank fragmentation effect. The paper is organized as follows. Section 2 describes the approach, which considers the supervisory structure as a path-dependent variable. The financial authorities concentration index (FAC Index) is used in Section 3 to identify this dependent variable. Then we recognize the importance of asking what role the central bank plays in the various national supervisory settings. The central bank as financial authority index (CBFA Index) is used to gauge the central bank's involvement in financial supervision. Using both the FAC Index and the CBFA Index, we confirm that the degree of supervision unification seems to be inversely proportional to the central bank's involvement in supervision (the central bank fragmentation effect).

Section 4 discusses the central bank fragmentation effect. The approach adopted considers the supervisory framework with one or more authorities as a rule-driven path dependent variable determined by the policymaker. We claim that the political choice of supervision concentration level will depend on the role the central bank plays in the supervision. The policymaker's choice can be viewed as a sequential process in which the institutional *status quo* counts: the supervision concentration level is decided based on the position of the central bank. If the role of the central bank is limited, the supervision concentration level will be high and vice versa. The central bank fragmentation effect is explained through moral hazard, bureaucracy, and reputation endowment effects.

[2] De Luna Martinez and Rose (2003) claimed that at least seven other countries were considering the adoption of a form of integrated supervision: Bulgaria, Indonesia, Poland, Slovakia, Slovenia and Ukraine.

[3] Masciandaro (2004).

[4] Grunbicher and Darlap (2003).

[5] Masciandaro (in press).