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Politicians and financial supervision unification outside the central bank: Why do they do it?

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ABSTRACT

An increasing number of countries show a trend towards a certain degree of consolidation of powers in financial supervision, which has resulted in the establishment of unified regulators, that are different from the national central banks. By contrast a high involvement of the central bank in supervision seems to be correlated with a multi-authorities regime (central bank fragmentation effect). This paper, using a simple application of a general common agency game, sheds light on which conditions the politicians prefer when implementing an unified sector supervision outside the central bank. From a theoretical point of view the quality of public sector governance plays a crucial role in determining the supervision unification. Focusing on the behaviour of the "good" policymaker (helping hand type), it will prefer a unified financial authority that is different from the central bank if the correspondent welfare gains-linked to at least one of the three effects: moral hazard, conflict of interest, bureaucracy—are considered higher respect to the information losses. The "bad" policymaker (grabbing hand type) will choose the single financial authority if the financial industry likes it, and the central bank is not a captured one. On the other hand, the paper tests the model, confirming the robustness of the institutional position of the central bank in explaining the recent trend in supervision consolidation, with an empirical analysis performed with ordered functions on an updated dataset.
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1. Introduction

Over the last few years the financial supervision landscape has been radically transformed. Many countries have made drastic changes to the architecture of financial supervision, and more are contem-

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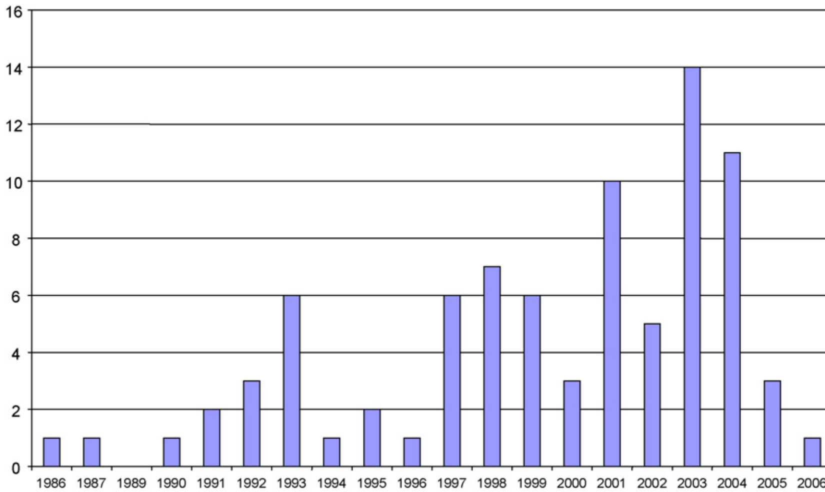

Fig. 1. Financial supervisory regimes: number of reforms per year (1986–2006).

plating modifications. In the last 20 years (1986–2006) 94% of the countries included in our sample of 91 nations chose to reform their financial supervisory setting (Fig. 1). The current restructuring wave is making the supervisory regimes less uniform than in the past. In several cases the architecture still reflects the classic model, with separate agencies for banking, securities and insurance supervision. However, an increasing number of countries show a trend towards a certain degree of consolidation of powers, which in several cases has resulted in the establishment of unified regulators, that are different from the national central banks.[1] Other countries are contemplating further modifications.

How can this supervision consolidation trend outside the central banks be explained? Firstly it is necessary to point out that the quest for the optimal level of financial supervision unification cannot be pursued through a traditional cost–benefit analysis. If one proposes to compare alternative models from a social welfare standpoint, one realises that each of them offers expected benefits but also expected risks, and the final outcome is actually undetermined. In general, different arguments for consolidation of supervision can be identified. However, there are also several arguments against unification, whose cons systematically mirror the pros. Different review essays (Abrams and Taylor, 2002; Cihak and Podpiera, 2007a,b) have demonstrated that there are not strong theoretical arguments in favour of any particular architecture of financial supervision, given that it is possible to provide advantages and disadvantages of each model.

Therefore, if the main driver of the supervisory reform cannot be the classic social welfare perspective, it is necessary to explore alternative views. Recent studies have tried to shed light on the determinants of the shape of the financial supervision, focusing on the policymakers' point of view.

In particular, when the policymakers implement a consolidation process, they seem to be influenced by the supervisory position of the central bank. Barth et al. (2002), Arnone and Gambini (2007) and Cihak and Podpiera (2007a) claim that the key issues for supervision are (1) whether there should be one or multiple supervisory authorities and (2) whether and how the central bank should be involved in supervision. More importantly, the two crucial features of a supervisory regime seem to be related.

The descriptive analysis (Masciandaro, 2004) signals an intriguing result: the national choices on how many agencies must be involved in supervision is strictly dependent on the existing institutional position of the central bank. The degree of unification seems to be inversely related to the central bank involvement in supervision. The trade-off – and the consequent so called central bank fragmentation

[1] For a survey see, e.g. De Luna Martinez and Rose (2003), Masciandaro (2005), and Cihak and Podpiera (2007b). The legal issues are described in Mwenda (2006).

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