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Central bankers as supervisors: Do crises matter?

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ABSTRACT

Following the 2007–09 Global Financial Crisis many countries have changed their financial supervisory architecture by increasing the involvement of central banks in supervision. This has led many scholars to argue that financial crises are an important driver in explaining the evolution of the role of central banks as supervisors. We formally test this hypothesis employing a new database that captures the full set of supervisory reforms implemented during the period 1996-2013 in a large sample of countries. Our findings support the view that systemic banking crises are important drivers of reforms in supervisory structure. However, we also highlight an equally important peer effect, namely a tendency of countries to reform their financial supervisory architecture when others do so as well. We construct several measures of spatial spillover effects and show that they can explain institutional similarities among countries and impact the probability of reforming the role of the central bank in financial sector supervision.

1. Introduction

What explains the reforms in the architecture of financial sector supervision? Throughout the 1990s and early 2000s, the creation of financial sector supervisors independent from the central bank has been generally associated with the reputational failures of many central banks during banking crises (Masciandaro, 2006; Masciandaro and Quintyn, 2009). Yet, following the 2007–09 Global Financial Crisis, many countries have actually increased the involvement of central banks in financial sector supervision, suggesting a sort of “great reversal” towards prudential supervision in the hands of central banks (Dalla Pellegrina et al., 2013). A classical example of this reversal is the evolution of the supervisory architecture in the United Kingdom between 1997 and 2013. In 1997, when the UK parliament voted to give its central bank operational independence with a clear objective of price stability, the responsibility for banking supervision was transferred from the Bank of England to the Financial Services Authority. However, the supervisory failure of this authority during the recent crisis led to its dismissal in 2013, with the supervisory powers being assigned to the newly established Prudential Regulation Authority, as a part of the Bank of England.

This trend towards increasing the involvement of central banks in financial sector supervision is common to a broader set of countries. Fig. 1 shows the degree of involvement of central banks in financial sector supervision in 1996 as compared to 2013 in a large set of countries. Using a new dataset constructed in this paper, we observe a clear tendency towards assigning central banks with the supervision of the entire financial sector, as darker shades of color depict an increasing number of financial sectors that fall under the responsibility of the central bank.

Yet, economic theory does not provide a clear answer as to whether assigning supervisory roles to central banks or other independent institutions is socially optimal. Masciandaro and Quintyn (2015) highlight two conflicting views regarding the merger of monetary and supervisory functions inside the central bank. An integration view underscores the informational advantages and

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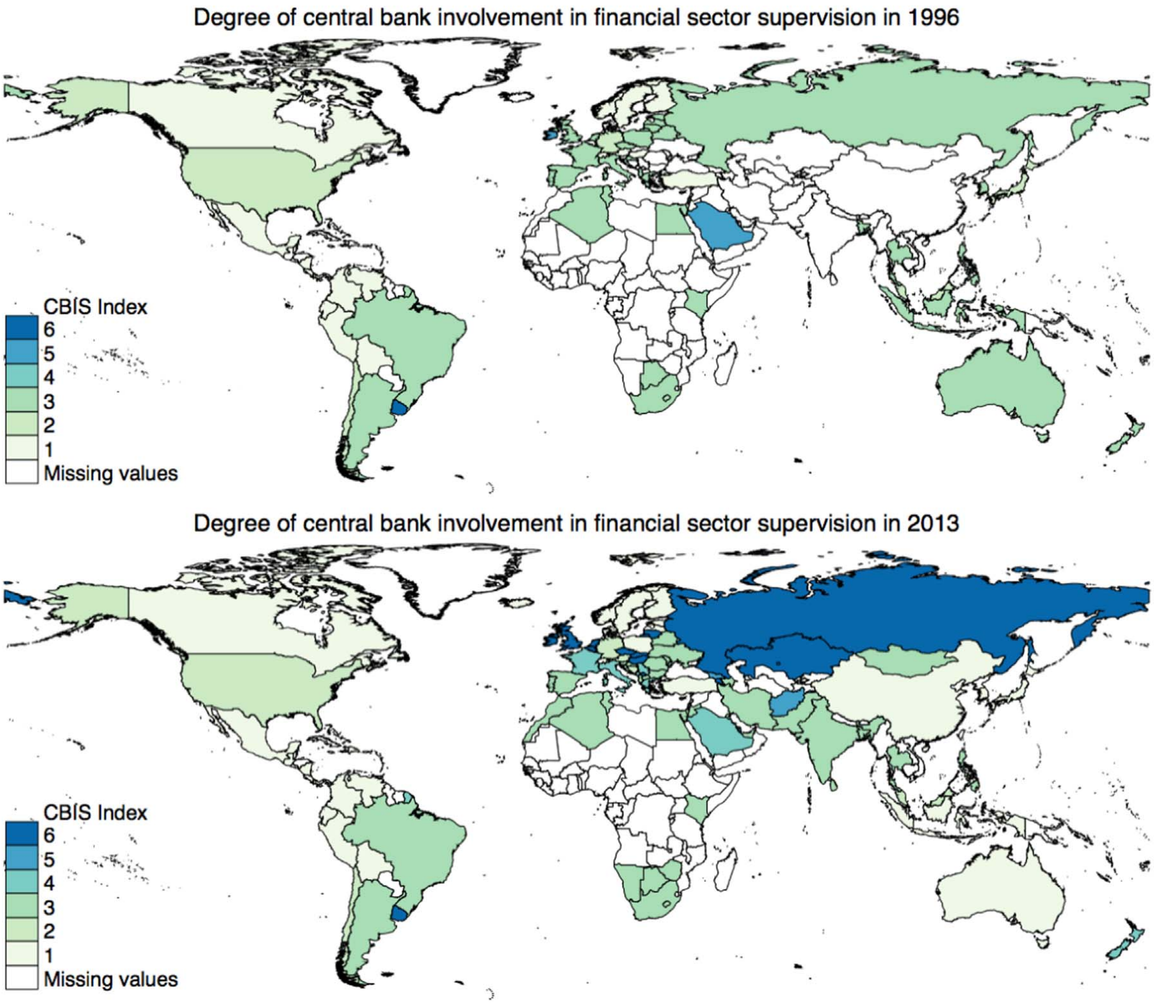

Fig. 1. Evolution of the degree of involvement of central banks in financial sector supervision (1996–2013), Notes: Figure compares the degree of involvement of central banks in financial sector supervision in 1996 as compared to 2013, using the index of central bank involvement in supervision (CBIS) constructed in this paper. Darker colours correspond to an increasing number of sectors that fall under the supervisory responsibilities of the central bank. (For interpretation of the references to color in this figure legend, the reader is referred to the web version of this article.)

economies of scale derived from bringing all functions under the authority of the central bank (Peek et al., 1999; Bernanke, 2007). Alternatively, a separation argument highlights the higher risk of policy failure, as financial stability concerns might impede the implementation of optimal monetary policies (Goodhart and Schoenmaker, 1995; Ioannidou, 2005; Berger and Kißmer, 2013). The empirical literature that has investigated the relative merits of assigning banking sector supervision in the hands of central banks also produces mixed results.[1]

In this paper, we propose a novel approach to understanding the cross-country evolution in the institutional design of financial sector supervisors. Our goal is to understand the determinants of reforms that increase the involvement of central banks in the supervision of the entire financial sector. To that end, we first create a new dataset containing information on the authorities responsible for the oversight of the financial sector (banking, insurance and financial markets) in a large sample of 105 countries, over the period 1996–2013. Using this data, we develop a new index of *Central Bank Involvement in Supervision* (CBIS Index, hereafter) that captures the roles of the central bank in supervising all, some or none of the different financial sector actors. This new index updates and extends previous attempts to measure financial sector supervision in several ways. First, previous indexes have

[1] For example, Arnone and Gambini (2007) find evidence in support of the integration view by highlighting the positive link between compliance with the Basel principles of supervision and the integration of supervisory powers inside the central bank. Peek et al. (1999) show that having supervisory information available improves the efficiency of the monetary policy function. On the other hand, Di Noia and Di Giorgio (1999) support the separation view by showing that inflation rates are higher and more volatile in countries where only the central bank is in charge of banking supervision. Chortareas et al. (2016) document that central banks serving both monetary policy and banking supervision functions are less inflation conservative. Similarly, Ioannidou (2005) finds that the FED's monetary policies do alter its banking supervisory activity, while Dincer and Eichengreen (2012) find evidence that nonperforming loans are lower if banking supervision is assigned to an independent authority different from the central bank.