2023 EBA Policy Research Workshop

Discussion of "Designing Agile Banking Supervision" by Kim, K. Kim, V. Liu and N. Tanner

Cyril Pouvelle

Autorité de Contrôle Prudentiel et de Résolution

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Outline

The issue and the paper

- Research question: what is the optimal disclosure strategy for the supervisor when both the supervisor and the bank have imperfect information about the state of the economy?
- Important contributions of this paper:
  - Robust modelling of the two-sided information uncertainty under a principal-agent problem where both sides have imperfect private information and have a conflict of interest;
  - Guidance on how the supervisor should allow or not a bank to take aggressive risk-taking depending on the signal he receives.

Main findings

- Main findings:
  - No single optimal disclosure strategy that supervisor can follow in all situations, depends on 2 factors: (i) signal informativeness; (ii) rejection cost incurred by the bank;
  - Full disclosure can yield lower payoffs to the supervisor;
  - The informativeness of the bank's signal, i.e. the probability that it corresponds to the right state of the economy (parameter γ), has a non-monotonic effect on welfare (the supervisor's expected payoff) due to two competing effects (information effect and control dilution), if the supervisor does not have any commitment power to the supervisory ruling.

Bank's objective

- Problem with the initial claim that banks always prefer to take aggressive risk management approach regardless of the state of the economy;
- $\Rightarrow$ How does this assumption reconcile with bank solvency regulation aimed at ensuring that banks' managers and banks' owners have "skin in the game"?
- Claim that there are multiple banks not perfectly observing the state variable
- $\Rightarrow$ How is bank heterogenity captured in the model?

Supervisor's objective

- Problem with the claim that the supervisor prefers banks to be conservative if economic fundamental is weak;
- $\Rightarrow$ How does this assumption reconcile with the new macroprudential approach to supervision, whereby regulation has to be countercyclical?
- How can micro- and macroprudential supervision interact in the model?

Policy implications

- Two main supervisory implications from the model to induce the bank to reveal adequate information:
  - giving the supervisor too much power in case the bank does not meet supervisory expectations;
  - giving the supervisor ex-ante commitment power over his supervisory ruling.
- Need to elaborate on the supervisory implications:
  - what about the risks of leakages of risk-taking into the unregulated sphere if the supevisor is being too conservative?
  - what should be the consequences for a bank of failing a stress test?

Conclusion

- Solid and interesting paper relying on a rigorous theoretical framework;
- Framework could be expanded to take into account recent developments in the field of macroprudential regulation and the development of the Non Banking Finanial Intermediation (NBFI).