3. Financial Supervision Architecture as Endogenous Variable: a Political Delegation Approach

The preceding Section made it manifestly evident that the quest for optimal financial supervision architecture cannot be pursued through a simple analysis of the costs and benefits expected from the possible alternative structures. If, in fact, one proposes to compare two counterpoised models—a Single Authority versus a system with Multiple Authorities—one realizes that each of them offers expected benefits but also expected risks. So a theoretical analysis of the *potential effects* of alternative supervisory structures does not take us very far.

The first natural response to this problem would therefore be to estimate the *real* effects the two alternative supervisory models have on key economic variables. But this immediately fosters at least three orders of difficulty.

Firstly, as we will show in the following Sections, the emergence of a Single Authority is only the most striking aspect of a more general and gradual phenomenon: diversification, from country to country, in the degree of unification of financial supervisory power. What has occurred is that, compared to the traditional model of control by sectors, some countries have confirmed that model, other have radically changed it by adopting a Single Financial Authority, while others have taken or confirm intermediate choices. This raises the problem of measuring the degree of concentration of powers, country by country, in order to attempt the quantitative description of a qualitative phenomenon.

Hence the first objective of the research agenda is to propose an indicator of this phenomenon to improve the *descriptive* analysis.

Secondly, the issue of the optimal degree of concentration of financial supervisory powers has emerged only recently, with the reforms adopted in various countries, so considering the type of supervisory regime as an explicative or *exogenous* (though not unique) variable of any other economic phenomenon means undertaking an analysis of extremely short historical series, with all the related problems of interpretation.

Thirdly, completely and satisfactorily identifying what the key economic variables are, and the most possible object of an estimate, on which a supervisory structure makes it effect felt, is not a simple problem. Alternative supervisory structures may, for example, affect the level of efficiency of the public resources invested in monitoring the financial markets. Indicators can be found for the efficiency phenomenon, and empirical analysis can therefore proceed.

The point is that alternative structures may also (perhaps especially) affect other variables that are important but less easily expressed in concise indicators. Examples are stability[38], reputation risk, or confident benefits, or the risk the authority will be captured by the policymakers or by the controlled intermediaries.

Thus a quantitative search for the effects of alternative supervisory structures is probably premature[39]. It might be interesting, rather, to ask: are there any common determinants in the

[38] On the elusive and ambiguous nature of the concept of financial stability from an empirical point of view see among others Garcia Herrero and del Rio (2003), Schoenmaker 2003, Grunbichler and Darlap (2003).

[39] Barth, Caprio and Levine (2001) empirically analyze the relationship between specific regulatory measures (capital ratios, deposit insurance, inspection rules, etc..), some bank performance indicators (asset growth, intermediation

decision each country makes to maintain or reform its control structure? Finding a response would help us not only to interpret what has happened in the past but also to project scenarios of change for the future.

Thus the second empirical objective of the research agenda is to attempt to concentrate on an analysis of the *causes* that have helped bring about a given supervisory structure, in one or more countries, so as to provided an econometric analysis.

The approach we intend to follow here—extending the indication that the new political economy[40] has formulated in analyzing the definition of public policies—is to consider the supervisory structure with one or more authorities as an *endogenous* variable, determined in turn by the dynamics of other structural variables, economic and institutional, that can summarize and explain the *political* process that leads a country to maintain or reform its supervisory structure.

A country confirms or reforms its supervisory structure when its policymakers decide it is advisable to do so. While we do not believe that policymakers are always and ever benevolent dictators, nor do we wish to exclude this *a priori*, we can assume that these decisions are generally determined, in turn, by structural factors of a financial, economic and institutional nature. The search for these factors is a task for economic analysis.

From the methodological standpoint[41], the analogy with the abundant, consolidated literature on the independence of central banks may be of some interest, since, if we look closely, this issue is nothing more than the quest for an optimal structure for the monetary agency.

In this literature, the theoretical models produced no general, univocal result regarding the desirability of a structure with an independent central bank versus one with a dependant monetary authority. In fact, considering the industrialized countries, while the relationship between independence and control over inflation seemed sufficiently robust and convincing[42], the relationship between independence, on the one hand, and fiscal and real variables[43], on the other, was far from certain. Thus the theoretical cost-benefit analysis of alternative monetary regimes could not be considered conclusive.

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margin, costs, loan losses) and institutional indicators (corruption). The difference from the analysis described here is evident: the object of analysis is the general design of the controls, not the individual rules of supervision. Above all, however, this work does not resolve the difficulties pointed out here: even individual supervisory measures have changed in various countries in recent years, so saying that all the data already fully reflect the effects of reforms is a rather bold statement; secondly, a complete judgment on the effects produced is not possible, since the set of performance indicators used is obviously partial. Barth, Nolle, Phumiwasana and Yago (2002) examine the relationship between the structure, scope and independence of bank supervision and bank profitability; the results indicate a weak relationship, and – more importantly for our methodological remarks – the authors estimates using an alternative source of data failed to duplicate this result. Demirguc-Kunt, Laeven and Levine (2003) examine the impact of bank regulations on bank interest margins and overhead costs; bank regulation however become insignificant when controlling for national indicators of economic freedom or property rights protection, that represent structural institutional variables in our terminology. Beck, Demirguc-Kunt and Levine (2002) examine the impact of bank supervision on the financial obstacles faced by corporation across 49 countries; the data are based on survey questions. Again our above remarks can be applied: here we have the perceptions by specific economic agents of the effects of supervision on specific set on indicators.

[40] For the new political economy approach see Persson and Tabellini (2000).

[41] For a recent and complete survey see Berger, de Haan and Eijffinger (2000).

[42] See Cukierman (1994) Berger, de Haan and Ejffinger (2000). See also Alesina and Gatti (1995)

[43] See Cukierman (1992).

We then went on to verify the theoretical conjectures with comparative, institutional and empirical analysis. After constructing indices of independence of the central banks[44], and having historical alternative models of independent and dependent monetary authorities[45], we attempted to determine whether the degree of legal independence could be considered an independent variable in explaining important macroeconomic phenomena: inflation, deficits and public debt, income and growth[46].

But above all, still on the methodological plane, the next step forward in the research was to *endogenize* the degree of central bank independence[47], in order to identify what economic and/or institutional structures could explain the decision of one or more countries to maintain or reform their monetary regimes, i.e. the degree of independence of their central banks.

The studies on endogenization of the degree of central bank independence were both theoretical and empirical and helped explain under what conditions a given country might decide to reform the institutional structure of its central bank, to modify its degree of independence.

Various interpretative hypotheses were advanced to explain the genesis of the political process that leads a monetary regime to assume given characteristics. Development in endogenizing central bank independence – or its effectiveness - has been the subject of analysis in both economics and political science. Some[48] revealed the possibility that the degree of central bank independence depends on the degree to which constituencies strongly averse to inflation are present, especially within the financial community, as political interest group, which drives policymakers to bolster the status of the central bank (*financial interest group*); others[49] have stressed that the features of the legislative and/or political system can influence policymakers to decide whether to have a structure of monetary powers with an independent central bank (*political interest group*) [50]; others have pointed out that the policymakers may have a specific interest in establishing an independent central bank in their country, for reasons linked to political stability[51] or international credibility[52]

[44] After the seminal central bank independence indices published by Grilli, Masciandaro and Tabellini (1991), followed by Cukierman indicators (1992), different indicators were proposed; for a discussion see Berger, de Haan and Eijffinger, (2000).

[45] See Toniolo (1988).

[46] See Alesina and Summer (1993), Cukierman (1994) and Berger, de Haan and Eijffinger (2000).

[47] See Masciandaro (1995) and Berger, de Haan and Eijffinger (2000); note the difference between institutional setting endogeneity and inflationary bias endogeneity.

[48] Maxfield (1994). Posen (1995), noting that there are distributive consequences in the choices of monetary regimes, stated that there is no reason to assume that the adoption of central bank independence is self-enforcing; that choice requires political support, and the financial sector is positioned to provide that support. De Haan and Van't Hag (1995) raised doubts about Posen's theory. On the relationships between financial sector preferences, low inflation and central bank independence see also van Lelyveld (2000).

[49] Moser (1999)

[50] Cukierman (1994); however his predictions are tested and rejected by Cukiermann and Webb (1995) and by De Haan and Van't Hag (1995). Vaubel (1997) suggests that central banks, even if formally independent, can be captured; Sieg (1997) proposes a formal model of a captured independent central bank. Bernhard (1998) claims that information asymmetries of the monetary policy process can create conflicts between government ministers, their backbench legislators and, in multiparty government, their coalition partners; an independent central bank can help overcome these conflicts. Goodman (1991) argues that conservative government with expected short tenure will adopt an independent central bank to limits the ability of future government; see also Milesi- Ferretti (1995). On the relationship between government partisanship and central bank structure see Alesina (1989), Alesina and Sachs (1988). Moser (1999) analyses the relationship between the central bank independence and the features (checks and balances) of the legislative systems; Keefer and Stasavage (2001) introduce a theoretical model and empirical evidence on this issue.

[51] Bagheri and Habibi (1998). De Haan and Van't Hag (1995) test the hyphotesis that government planning to incur higher deficits may wish to increase credibility granting more central bank independence; no supporting evidence is found. The importance of central bank law design for the central bankers is clearly claimed in Poole (2003).

(*specific public interest*); others[53] have stressed the role of the culture and of the tradition of monetary stability in a country or the importance of the citizen preferences[54] (*general public interest*).

It is evident that studies of this type acquire great importance, especially in periods when there is a tendency to reform or at least to question the design of the rules. And while in the past this was the case with analyses of central bank independence, it now applies for the first time to the debate on authorities in the financial field. In fact to the best of our knowledge no studies examine the relationships between politics and financial supervisory architecture[55].

In conclusion, regarding the issue of financial supervisory models, there are obvious analogies of approach with the debate on central bank independence, as well as one principal difference: in our case, we are "forced" to skip the first phase - exogeneity - and attempt the endogeneity approach directly.

Finally, the endogenization of the policymaker's choice of the optimal level of concentration in the supervisory architecture will be more effective, however, if analyzed as a problem of delegation, through a principal–agent approach. Principal-agent models have found interesting applications in the area of monetary policy studies[56]: it is in the interest of the policymaker (the principal) to delegate the conduct of anti-inflationary monetary policy to an independent central bank (the agent), because this makes that policy more effective.

The principal–agent approach can also be applied to the problem being examined here, even though the degree of complexity is rather greater.

The first step is to explain which objective (What?) the policymaker intends to pursue in delegating the supervisory policy over the banking, financial and insurance system. The second step is to analyze the policymaker wishes (Why?) to delegate this policy rather than implement it directly, and whether his choices are motivated by general interests or are captive to specific interests[57]. The third step is to ask how many institutions the policymaker delegates this policy to (How many?) and, step four, which institution(s) he utilizes (Who?). What we are proposing here is a political delegation approach[58] in dealing with the financial supervisory architecture issues.

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[52] Maxfield (1997).

[53] Berger (1997), Berger and de Haan (1997). Hayo (1998) claim that people's preferences with respect to price stability matter in explaining low inflation rate, and that the central bank independence is just one aspect of a stability regime, with two competing interpretation on the role of the institutional design: preference – instrument interpretation versus historical-feedback interpretation. Franzese (1999) claims that the effectiveness of central bank independence depends on every variable in the broader political – economic environment.

[54] Eggertsson and Le Borgne (2003).

[55] In general, there are few recent examples of studies on politics and banking ;for a survey see Pagano and Volpin (2001).

[56] For a survey see Masciandaro (1995), Berger, de Haan and Eijffinger (2000).

[57] See Stigler (1971), Laffont and Tirole (1991). For a Stiglerian view of bank regulation see Heinemann and Schuler (2003).

[58] A recent paper – Alesina and Tabellini (2003) – proposed a general model in order to investigate the criteria that should lead a society to allocate policy tasks to elected policymakers (politicians) or non elected bureaucrats. The delegation approach to the monetary policy analysis has been proposed by Persson and Tabellini (1993), Walsh (1995), Svensson (1997), Fratianni, Von Hagen and Waller (1998), in order to solve the inflation bias stemming from a dynamic inconsistent problem. Eggertsson and Le Borgne (2003) proposed a model to explain why, and under what circumstances, a politician gives up rent and delegate policy tasks to an independent agency, applying this theory to the monetary policy.