

## 2. Policymaking and the Unification of Financial Supervision

Our starting point is the blurring effect that is taking place in the banking and financial industry<sup>6</sup>. There has been increasing integration of the banking, securities and insurance markets, as well as their respective products and instruments. The blurring effect causes two interdependent phenomena: 1) the emergence of *financial conglomerates*<sup>7</sup>, which is likely to produce important changes in the nature and dimensions of the individual intermediaries, as well as in the degree of unification of the banking and financial industry; and 2) growing *securitisation* of the traditional forms of banking activity and the proliferation of sophisticated ways of bundling, repackaging and trading risks, which weaken the classic distinction between equity, debt and loans<sup>8</sup>, bringing changes in the nature and dimensions of the financial markets.

The blurring process proposes different questions in the debate on financial supervision architecture, but the most important one is the alternative between the single authority model and the financial multi - authority model<sup>9</sup>. Identifying the optimal supervisory regime between the two alternatives is an interesting problem.

It has been correctly claimed that no “superior” model of supervision exists<sup>10</sup>. The quest for the optimal supervision architecture cannot be pursued through a simple traditional analysis of the costs and benefits expected from the possible alternative structures. If, in fact, one proposes to compare the two models, he realizes that each of them offers expected benefits but also expected risks<sup>11</sup>. So a theoretical analysis of the *potential effects* of alternative supervisory structures does not take us very far.

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<sup>6</sup>See Dale (1997) and White (1997).

<sup>7</sup>See European Commission (2002) and de Luna Martinez and Rose (2003).

<sup>8</sup>De Luna Martinez and Rose (2003).

<sup>9</sup>See Masciandaro (2004).

<sup>10</sup>Briault (2002), Schoenmaker (2003).

<sup>11</sup>For a survey see Masciandaro and Porta (2004).

Actually, gains and losses of a supervisory model are *expected* variables, calculated by the policymakers that maintain or reform the supervisory regime. But the expectations of policymakers, given their own specific goals, are likely to be influenced by structural economic and institutional variables, which may vary from country to country. Therefore the supervisory regime is *not* deterministic, nor, on the other side, completely accidental.

On the contrary, given the national economic and institutional endowment, these variables can determine, *ceteris paribus*, the policymakers' expected gains or losses of a specific supervisory regime. The supervisory regime can become the dependent variable, in a *path dependence* framework. Furthermore, the economic agents have not information on the true preferences of the policymaker: his optimal degree of financial supervision unification is a *hidden variable*.

In the economic literature there are not yet theoretical studies that consider the policymaker objective function for the financial supervisory design<sup>12</sup>. The crucial issue is the identification of the policymaker preferences.

The first approach to identify the policymaker's function could be the so called *narrative approach*<sup>13</sup>, in which official documents are interpreted to gauge the policymaker choices. This approach has the drawback that there is substantial room for differences between the policymaker announcements and his true preferences.

The second approach - which we intend to follow here - is to consider the policymaker actual choices in determining the level of financial supervision unification (*factual approach*). In each random point of time, we observe the policymaker decision to maintain or reform the

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<sup>12</sup>The problem could be analysed as a model of political delegation, trying to apply in the financial supervisory field the general framework proposed in Alesina and Tabellini (2003). The delegation approach has been recently used to debate financial supervisory issues in Bjerre-Nielsen (2004) and in Eisenbeis (2004). There are two theoretical model on the banking supervision architecture – Repullo (2000) and Kahn and Santos (2004) - but without any explicit identification and discussion of the policymaker (lawmaker) objective function.

<sup>13</sup>The narrative approach has been extensively used in the monetary policy literature: see Potts and Lockett (1978), Wallace and Warner (1985), Hakes (1988) and (1990), Romer and Romer (1989).

financial supervision architecture, choosing the level of unification. In other words we consider policymakers faced with discrete choices.

Building in a cross country perspective an empirical analysis consistent with this discrete choice process involves claiming the existence of unobservable policymaker utilities  $U_{ij}$ , where each  $U_{ij}$  is the utility received by the  $i$ th national policymaker from the  $j$ th level of financial unification. Since the utility  $U_{ij}$  is unobservable, we represent it as a random quantity, assuming that is composed of a systematic part  $U$  and a random error term  $\varepsilon$ . Furthermore, we claim that the utilities  $U_{ij}$  are function of the attributes of the alternative institutional level of financial unification and of the structural characteristics of the policymaker country.

Combining the two hypotheses, we have a random utility framework for the unobservable financial unification variable. As usual, we assume that the errors  $\varepsilon_{ij}$  are independent for each national policymaker and institutional alternative, normally distributed. The independence assumption implies that the utility derived by one national policymaker is not related to the utility derived by any other national policymaker, and that the utility that a policymaker derives from the choice of a given level of financial unification is not related to the utility provided by the other alternative<sup>14</sup>.

In the factual approach the first crucial issue is the measurement of the policymaker choices, that is the definition of the dependent variable<sup>15</sup>.

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<sup>14</sup>See Maddala (1983), Greene (1997) and Wooldrige (2002) for in-depth discussion on the random utility models that generate discrete dependent variables.

<sup>15</sup>The factual approach has the drawback that there is subjectivity in the institutional measurements. However the subjectivity in the interpretation is also present in the narrative approach.