Discussion of Multiple safety net regulators and agency problems in the EU: Is Prompt Corrective Action partly the solution?

Mayes, Nieto and Wall

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Overview of paper

- This paper evaluates a refined PCA approach, which aims to address agency problems in safety net regulation, in the presence of cross-border banking groups.

- Topic is highly relevant: Agency problems in regulation are large – and they are especially large in the case of cross-border banking groups.

- Paper argues effective PCA requires:
  - Enhancement in availability of information.
  - Collective decision making when cross-border bank falls below minimum capital standard.
  - Coordination measures if banks must be resolved.

Agency cost of equity in nonfinancial firms

- Agents (managers) may not act purely in the interests of their principals (shareholders).
  - Avoid risk taking
  - Collude with customers
  - Divert cash flows
  - Empire building
  - Exert suboptimal effort

  - Agency costs highlighted during crises
  - Agency costs highlighted if diverse ownership (multiple principals)
  - Agency costs large if lots of "free cash flow"

  - Typical solutions in finance:
    - Takeovers, options, equity stakes, bonus plans, large owners…

Agency costs of debt in nonfinancial Firms

- Agents (shareholders) may not act in the interest of their principals (debt holders)

  - Excessive risk taking
  - Divert cash flows to equity holders
  - Exert suboptimal effort

  - Agency costs highlighted during crises

  - Typical solutions in finance:
    - Covenants (restricting actions of agents), reduced debt
    - Bankruptcy laws (transfer of control)

Agency costs in supervision?

- **Agents (supervisors) may not act purely in the interests of their principals (voters)**
  - Agency costs highlighted during crises (safetynet regulation)
  - Agency problems highlighted if multiple principals
  - Lots of “free cash flow”

- **Agency costs:**
  - Avoid risk taking / excessive risk taking ?
    - Avoiding mistakes can be a mistake!
  - Collude with those regulated ?
  - Divert cash flows ?
  - Empire building ?
    - Disinterest in developing unregulated areas of finance
  - Exert suboptimal effort ?
    - E.g. timely and decisive effort to solve crises

Agency costs in supervision?

Solutions along the lines of corporate finance:

- More concentrated supervision (in case of multinationals), independent board, takeover threat (ECB?), bonus plans?
- Covenants (states when agents must act), reduced entry (licences) of banks

- Suggested PCA:
  – Covenants (mandatory supervisory interventions as a bank's regulatory capital falls; suspension of dividends),
  – larger regulatory bodies (college of supervisors)

- Note: PCA deals also with the agency problem between bank (agent) and supervisor (principal). E.g. through transfer of control.

Additional agency problems related to regulation of cross-border banking groups

- **Claim:**
  - regulators in crises put their home country's national interests ahead of those of other countries and this can lead to suboptimal decision making. Lack of coordination and timely information results in waste of time (and thus money). Parent's supervisor (with much of the control) is not concerned about tax payers in subsidiary's country.

- **I agree:**
  - It is important to have timely and complete information (common database seems highly important – also using various forms of market information as suggested by authors).
  - It is important to know who has authority and responsibility over decision making and have a clear plan of action in crises.
  - Homebias (independence) must be dealt with seriously.

  - It would seem that regulation of these institutions should be centralized and done by international professionals who have small homebias. **College of regulators seems better than existing solution.**

Prompt Corrective Actions (PCA) as a solution in Europe

- This paper deals with this important issue in a clear and convincing manner. Based in this analysis
  - It seems PCA has many attractive features to deal with Agency costs !
  - But effective PCA for multinationals requires:
    - Enhancement in availability of information
    - Collective decision making when cross-border bank falls below minimum capital standard
    - Coordination measures in case of resolution