The Economics of Bank Supervision

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Abstract

We use unique data on work hours of Federal Reserve bank supervisors and a structural model to provide new insights on the impact of bank supervision, the efficiency of the allocation of supervisory resources, and the shape of supervisory preferences. We find that supervision has an economically large effect in lowering bank distress and that the supervisory cost function displays large economies of scale with respect to bank size. Estimated supervisory preferences weight larger banks more than proportionally, consistent with macro-prudential objectives, and especially so after 2008 when resources were reallocated to large banks. This reallocation lowered risk at large banks less than it increased risk at small banks. We show evidence of frictions that prevent an efficient allocation of resources both within and across Federal Reserve districts. Model counterfactuals quantify the benefits of reducing these frictions, especially for the riskiest banks.

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