



Regulatory Supervision, Trust And Distance

regulatory

Summary: Hub-and-spoke regulation is reviewed by industry researchers. Some of the interesting findings are revealed.

At the end of last year, some fool in Virginia tried to steal a car. While that sort of thing happens all the time around the country, this brainy crook took steps to look even dumber when he was caught. When arrested that same day, the police laughed when this fool was wearing a t-shirt that read, "Trust Me." We found this very comical indeed.

It turns out banking industry researchers from Washington University in St. Louis have been having fun of another type as of late. They dove deep into the data to take a close look at [hub-and-spoke regulation](#) common in the US and Europe in an effort to see whether it could lead to problems or increase the risk of bank failure. The results are interesting.

To begin, a hub-and-spoke structure is one where a central regulator delegates monitoring of banks to local supervisors. The biggest issue in such a structure occurs when the objectives of local regulators "at the spokes differ from those of the central regulator at the hub." Here, the research points out that distancing regulatory supervisors from banks actually increases risk.

In short, after looking at the closure of regulatory field offices, the paper, which examined the relationship between banking regulatory field offices and the accounting quality of small and medium sized banks between 1984 and 2013, found that the farther a regulatory office is located from the banks it monitors, the lower the quality of information captured.

Over time, researchers found that banks that were geographically closer to regulators operating in the area seemed to also have less risk and a lower likelihood of failure. The analysis found that when regulators closed offices in a specific region, banks in that area moved to distribute more cash to shareholders, increase their leverage and thereby increase their likelihood of failure vs. banks where this did not occur.

To go deeper, researchers also looked at local economic conditions. They wanted to see if there was a correlation to regulatory office closures and bank leverage and to see if it impacted state chartered banks within the same area. They could not find any evidence of this.

Yet another finding here relates to regulatory proximity and the resulting information flows. It seems that being closer to regulators that supervise the bank, allows banks and regulators to gather soft information that might not be accessible from a longer distance. It also seems that an increase in distance can increase the cost of regulation and thereby impact oversight.

Since regulatory oversight of banks is done both on and off premises, when banks are physically distant from regulatory offices, the costs involved in gathering information and monitoring banking activities increase.

Because of this, regulatory oversight from regulators that are near to the bank can include better knowledge of local economic conditions that can directly impact the bank. As such, this tends to make such oversight

significantly better than more distant review.

While it remains to be seen whether technology has made it so easy for distant regulatory teams to keep tabs on banks in faraway geographies, we still tend to lean local. Nonetheless, we will keep monitoring this and periodically report back so you can see where things are heading and how fast they might get there to give you time to adjust.

DEPOSIT OPPORTUNITIES

In an effort to expand our relationships, PCBB is pleased to offer community banks a money market deposit account rate of 1.60%, subject to availability. Contact operations@pcbb.com.

Copyright 2021 PCBB. Information contained herein is based on sources we believe to be reliable, but its accuracy is not guaranteed. Customers should rely on their own outside counsel or accounting firm to address specific circumstances. This document cannot be reproduced or redistributed outside of your institution without the written consent of PCBB.