"Regulation Funded by Regulated Firms: Evidence from Banking”

Prof. Asaf Manela
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Abstract

In many industries, regulation is funded with user fees paid by regulated firms, as opposed to with general public taxation. Despite the prevalence of user-fee-funded regulation, we know little about its effects on the regulatory process. Theoretically, this approach to regulation may promote a more efficient and equitable use of resources. However, it may also expose the system to regulatory capture and favoritism, as well as increased budget uncertainty. We use the banking sector as a laboratory to study, theoretically and empirically, the effect of “user fees” models on regulation. We use a novel dataset of fees paid by national banks and thrifts to their federal regulators over the last three decades. Our identification strategy uses kinks in the fee schedules faced by the banks as a source of exogenous variation in fees. Importantly, since fees are determined by bank size, and the schedules feature multiple kink points, we can estimate the treatment effect of regulatory fees for a wide spectrum of banks. Our results suggest that regulatory fees have a significant impact on the regulatory process. We find that an increase in regulatory fees significantly decreases banks’ regulatory capital ratios, increases their loan-loss reserves, and decreases the probability of leaving their regulators.