Structuring Bank Soundness Regulation

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Mr. Chairman, Senator Shelby, Members of the Committee:

You hold these hearings in response to an extraordinary financial debacle, costly and far-reaching: a debacle that has caused worldwide pain and will saddle our children with an oversized public debt. "And yet," to echo President Franklin D. Roosevelt's inaugural address, "our distress comes from no failure of substance. We are stricken by no plague of locusts. . . . Plenty is at our doorstep." Our financial system got into extraordinary trouble—trouble not seen since the Great Depression—during a time of record profits and great prosperity.

This disaster had many causes, including irrational exuberance, poorly understood financial innovation, loose fiscal and monetary policy, market flaws, regulatory gaps, and the complacency that comes with a long economic boom. But our focus here is on banking, where the debacle was above all a *regulatory* failure. Banking is one of our most heavily regulated industries. Bank regulators had ample powers to constrain and correct unsound banking practices. Had regulators adequately used those powers, they could have made banking a bulwark for our financial system instead of a source of weakness. In banking, as in the system as a whole, we have witnessed the greatest regulatory failure in history. Our fragmented bank regulatory structure contributed to the debacle by impairing regulators' ability and incentive to take timely preventive action. Reform of that structure is long overdue.

In my testimony today, I will:

(1) note how regulatory fragmentation has grave defects, arose by happenstance, and persists not on its merits but through special-interest politics and bureaucratic obduracy;

(2) recommend that Congress unify banking supervision in a new independent agency; and

(3) reinforce the case for reform by explaining how regulatory fragmentation helps give regulators an unhealthy set of incentives—incentives that hinder efforts to protect bank soundness, the federal deposit insurance fund, and the taxpayers.

I. FRAGMENTATION IMPEDES EFFECTIVE SUPERVISION

Fragmentation Is Dysfunctional

Our fragmented bank regulatory structure is needlessly complex, needlessly expensive, and imposes needless compliance costs on banks. It "requires too many banking organizations to deal with too many regulators, each of which has overlapping, and too often maddeningly different, regulations and interpretations," according to Federal Reserve Governor John LaWare. It engenders infighting and impedes prudent regulatory action.

FDIC Chairman William Seidman deplored the stubbornness too often evident in interagency negotiations: “There is no power on earth that can make them agree—not the President, not the Pope, not anybody. The only power that can make them agree is the Congress of the United States by changing the structure so that the present setup does not continue.” The current structure promotes unsound laxity by setting up interagency competition for bank clientele. It also blunts regulators’ accountability with a tangled web of overlapping jurisdictions and responsibilities. Comptroller Eugene Ludwig remarked that “it is never entirely clear which agency is responsible for problems created by a faulty, or overly burdensome, or late regulation. That means that the Congress, the public, and depository institutions themselves can never be certain which agency to contact to address problems created by a particular regulation.”

Senator William Proxmire, longtime chairman of this committee, called this structure “the most bizarre and tangled financial regulatory system in the world.” Treasury Secretary Lloyd Bentsen branded it “a spider’s web of overlapping jurisdictions that represents a drag on our economy, a headache for our financial services industry, and a source of friction within our Government.” Chairman Seidman derided it as “complex, inefficient, outmoded and archaic.” The Federal Reserve Board declared it “a crazy quilt of conflicting powers and jurisdictions, of overlapping authorities, and gaps in authority” (and that was in 1938, when the system was simpler than now). Federal Reserve Vice Chairman J.L. Robertson went further:

> The nub of the problem . . . is the simple fact that we are looking for, talking about, and relying upon a system where no system exists. . . . Our present arrangement is a happenstance and not a system. In origin, function, and effect, it is an amalgam of coincidence and inadvertence.

Opponents of reform portray a unified supervisory agency as ominous and unnatural. Yet although the federal government regulates a wide array of financial institutions, no other type of institution has competing federal regulators. Not mutual funds, exchange-traded funds, or other regulated investment companies. Not securities broker-dealers. Not investment advisers. Not futures dealers. Not government-sponsored enterprises. Not credit unions. Not pension funds. Not any other financial institution. A single federal regulator is the norm; competition among federal regulators is an aberration of banking.

Federal Financial Institution Regulators	
Institution Type	***Agency***
Futures dealers	Commodity Futures Trading Commision
GSEs—Agricultural	Farm Credit Administration
GSEs—Housing	Federal Housing Finance Agency
Pension funds	Internal Revenue Service; Dept. of Labor
Credit unions	National Credit Union Administration
Investment advisers	Securities & Exchange Commission
Investment companies	Securities & Exchange Commission
Securities broker-dealers	Securities & Exchange Commission

Nor do we see competition among federal regulators when we look beyond financial services—and for good reason. Senator Proxmire observed:

> Imagine for a moment that we had seven separate and distinct Federal agencies for regulating airline safety. Imagine further the public outcry that would arise

> following a series of spectacular air crashes while the seven regulators bickered among themselves on who was to blame and what was the best way to prevent future crashes.
>
> There is no doubt in my mind that the public would demand and get a single regulator. There is a growing consensus among experts that our divided regulatory system is a major part of the problem. There are many reasons for consolidating financial regulations, but most of them boil down to getting better performance.

Fragmentation is the Product of Happenstance

Two forces long shaped American banking policy: distrust of banks, particularly large banks; and crises that necessitated a stronger banking system. Our fragmented regulatory structure reflects the interplay between these forces. As FDIC Chairman Irvine H. Sprague noted, this structure "had to be created piecemeal, and each piece had to be wrested from an economic crisis serious enough to muster the support for enactment."

Distrust of banking ran deep from the beginning of the Republic. John Adams, sober and pro-business, declared that "banks have done more injury to the religion, morality, tranquility, prosperity, and even wealth of the nation than they have done or ever will do good." Thomas Jefferson asserted that states "may exclude [bankers] from our territory, as we do persons afflicted with disease." Andrew Jackson won reelection pledging to destroy the nation's central bank, which he likened to a malicious monster. This powerful, longstanding distrust of banking shaped U.S. law in ways that, until recent decades, kept U.S. banks smaller and weaker (relative to the size of our economy) than their counterparts in other developed countries.

Yet banking proved too useful to ignore or suppress. To cope with financial emergencies, Congress acted to strengthen the banking system. It created:

- national banks to finance the Civil War and the OCC to supervise national banks;
- the Federal Reserve in response to the Panic of 1907;
- the FDIC, its thrift-institution counterpart, and the federal thrift charter to help stabilize the financial system during the Great Depression; and
- the Office of Thrift Supervision in response to the thrift debacle of the 1980s.

These and other ad hoc actions gave us a hodgepodge of bank regulatory agencies unparalleled in the world. Each agency, charter type, and regulatory subcategory developed a political constituency resistant to reform.

The Bank Holding Company Act, another product of happenstance, exacerbated this complexity. It ultimately gave most banking organizations of any size a second federal regulator: the Federal Reserve Board. As enacted in 1956, the Act sought to prevent "undue concentration of economic power" by limiting banks' use of holding companies to enter additional businesses and expand across state lines. The Act reflected a confluence of three disparate forces: populist suspicion of bigness in banking; special-interest politics; and the Federal Reserve Board's desire to bolster its jurisdiction. Representative Wright

Patman, populist chairman of the House Banking Committee, sought to prevent increased concentration in banking and the broader economy. Small banks sought to keep large banks from expanding into new products and territory. A variety of other firms sought to keep banks out of their businesses. The Fed gained both expanded jurisdiction and a respite from Chairman Patman's attempts to curtail its independence in monetary policy.[1] The Act originally applied only to companies owning two or more banks. But in 1970 Congress extended the Act to companies owning a single bank.

Special-Interest Politics Perpetuate Fragmentation

Regulatory fragmentation leaves individual agencies smaller, weaker, and more vulnerable to pressure than a unified agency would be. It can also undercut their objectivity. Fragmentation played a pivotal role in the thrift debacle. Specialized thrift regulators balked at taking strong, timely action against insolvent thrifts. Regulators identified with the industry and feared that stern action would sharply shrink the industry and jeopardize their agencies' reason for being. In seeking to help thrifts survive, the regulators multiplied the ultimate losses to the deposit insurance fund and the taxpayers. For example, they granted sick thrifts new lending and investment powers for which the thrifts lacked the requisite competence (e.g., real estate development and commercial real estate lending).

By contrast, bank regulators who also regulated thrifts took firmer, more appropriate action (e.g., limiting troubled institutions' growth and closing deeply insolvent

[1] Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* 99-100 (1994).

institutions). These policies bore fruit in lower deposit insurance losses. State-chartered thrifts regulated by state banking commissioners were less likely to fail—and caused smaller insurance losses—than thrifts with a specialized, thrift-only regulator. Likewise, thrifts regulated by the FDIC fared far better than those regulated by the thrift-only Federal Home Loan Bank Board.

II. UNIFYING FEDERAL BANK SUPERVISION

Fragmentation problems have a straightforward, common-sense solution: unifying federal bank regulation. Treasury Secretary Lloyd Bentsen offered that solution here in this room 15 years ago. As Assistant Secretary of the Treasury for Financial Institutions, I worked with him in preparing that proposal. He made a cogent case then, and I'll draw on it in my testimony now.

Secretary Bentsen proposed that we unify the supervision of banks, thrifts, and their parent companies in a new independent agency, the Federal Banking Commission. The agency would have a five-member board, with one member representing the Treasury, one member representing the Federal Reserve, and three independent members appointed by the President and confirmed by the Senate. The President would designate and the Senate confirm one of the independent members to head the agency.

The commission would assume all the existing bank regulatory responsibilities of the Comptroller of the Currency, Federal Reserve Board, FDIC, and Office of Thrift Supervision. The Federal Reserve would retain all its other responsibilities, including monetary policy, the discount window, and the payment system. The FDIC would retain all its powers and responsibilities as deposit insurer, including its power to conduct special examinations, terminate insurance, and take back-up enforcement action. The three agencies' primary responsibilities would correspond to the agencies' core functions: bank supervision, central banking, and deposit insurance.

This structure would promote clarity, efficiency, accountability, and timely action. It would also help the new agency maintain its independence from special-interest pressure. The agency would be larger and more prominent than its regulatory predecessors and would supervise a broader range of banking organizations. It would thus be less beholden to a particular industry clientele—and more able to carry out appropriate preventive and corrective action. Moreover, a unified agency could do a better job of supervising integrated banking organizations—corporate families in which banks extensively interact with their bank and nonbank affiliates. The agency would look at the whole organization, not just some parts. Secretary Bentsen put the point this way:

> Under today's bank regulatory system, any one regulator may see only a limited piece of a dynamic, integrated banking organization, when a larger perspective is crucial both for effective supervision of the particular organization and for an understanding of broader industry conditions and trends.

Having the same agency oversee banks and their affiliates both simplifies compliance and makes supervision more effective. We have no need for a separate holding company regulator.

Under the Bentsen proposal, the Fed and FDIC would have full access to supervisory information about depository institutions and their affiliates. Their examiners could participate regularly in examinations conducted by the commission and maintain their expertise in sizing up banks. As members of a Federal Banking Commission-led team, Fed and FDIC examiners could scrutinize the full spectrum of FDIC-insured depository institutions, including national banks. The two agencies would have all the information, access, and experience needed to carry out their responsibilities.

The Treasury consulted closely with the FDIC in developing its 1994 reform proposal. The FDIC supported regulatory consolidation in testimony before this committee on March 2, 1994. It stressed that in the context of consolidation it had five basic needs. First, to remain independent. Second, to retain authority to set insurance premiums and determine its own budget. Third, to have "timely access" to information needed to "understand and stay abreast of the changing nature of the risks facing the banking industry . . . and to conduct corrective resolution and liquidation activities." Fourth, to retain power to grant and terminate insurance, assure prompt corrective action, and take back-up enforcement action. Fifth, to retain its authority to resolve failed and failing banks.

A regulatory unification proposal can readily meet all five of those needs. Indeed, Secretary Bentsen's proposal dealt with most of them in a manner satisfactory to the FDIC. The Treasury and FDIC did disagree about FDIC membership on the Federal Banking Commission. The FDIC regarded membership as an important assurance of obtaining timely information. The Treasury proposal did not provide for an FDIC seat, partly out of concern that it would entail expanding the commission to seven members. Now as then, I believe that the agency's board should include an FDIC representative.

The Federal Reserve and FDIC complain that they cannot properly do their jobs unless they remain the primary federal regulator of some fraction of the banking industry. These complaints ignore the sort of safeguards in Secretary Bentsen's proposal. They also exaggerate the significance of the two agencies' current supervisory responsibilities. FDIC-supervised banks hold only 17% of all FDIC-insured institutions' aggregate assets; Fed-supervised banks, only 13%. Nor does the Fed's bank holding jurisdiction fundamentally alter the picture: the Fed as holding company regulator neither examines nor supervises other FDIC-insured institutions. The Fed and FDIC, in carrying out their core responsibilities, *already* rely primarily on supervisory information provided by others.

Thus it strains credulity to suggest that the FDIC cannot properly carry out its insurance and receivership functions unless it remains the primary federal regulator of state nonmember banks. These banks, currently numbering 5,040, average $460 million in total assets. How many community banks must the FDIC supervise to remain abreast of industry trends and remember how to resolve a community bank? Likewise, the Fed cannot plausibly maintain that its ability to conduct monetary policy, operate the discount window, and gauge systemic risk appreciably depends on remaining the primary federal regulator of 860 state member banks (only 10% of FDIC-insured institutions), particularly when those banks average less than $2 billion in total assets. Moreover, according to the most recent Federal Reserve Flow of Funds accounts, the entire commercial banking industry (including U.S.-chartered commercial banks, foreign banks' U.S. offices, and bank holding companies) holds only some 18% of our nation's credit-market assets. In sum, the two agencies' objections to reform ring false. They are akin to saying, "I can't do my job right without being the supreme federal regulator for some portion of the banking industry, small though that portion may be. Nothing else will do."

Nor do regulatory checks and balances depend on perpetuating our multi-regulator jumble. "Regulatory power is not restrained by creating additional agencies to perform duplicate functions," Secretary Bentsen rightly declared. A unified banking supervisor would face more meaningful constraints from "congressional oversight, the courts, the press, and market pressures." Its decisionmaking would also, under my recommendations, include the insights, expertise, and constant participation of the Federal Reserve Board and FDIC.

III. REGULATORY FRAGMENTATION PROMOTES UNSOUND LAXITY

Most debate about banking regulation pays little heed to bank regulators' incentives. That's a serious mistake, all the more so given the recent debacle. As noted at the outset, regulators had ample powers to keep banks safe but failed to do so. This failure partly involved imperfect foresight (an ailment common to us all). But it also reflected an unhealthy set of incentives—incentives that tend to promote unsound laxity. These incentives discouraged regulators from taking adequate steps to protect bank soundness, the federal deposit insurance fund, and the taxpayers. Economists refer to such incentives as “perverse” because they work against the very goals of banking regulation. These incentives represent the regulatory counterpart of moral hazard. Just as moral hazard encourages financial institutions to take excessive risks, these incentives discourage regulators from taking adequate precautions. To improve regulation, we need to give regulators a better set of incentives—incentives more compatible with protecting the FDIC and the taxpayers.

Several key factors create perverse incentives for bank regulators. First, we have difficulty telling good regulation from bad—until it’s too late. Second, lax regulation is more popular than stringent regulation—until it’s too late. Third, regulators’ reputations suffer less from what goes wrong on their watch than from what comes to light on their watch. This is the upshot:

BANK SOUNDNESS REGULATION HAS
NO POLITICAL CONSTITUENCY
—UNTIL IT’S TOO LATE.

To make the incentive problem more concrete, put yourself in the position of a regulator who, during a long economic boom and a possible real estate bubble, sees a need to raise capital standards. The increase will have short-term, readily identifiable consequences. To comply with the new standards, banks may need to constrain their lending and reduce their dividends. Prospective borrowers will complain. Banks’ return on equity will decline because banks will need more equity per dollar of deposits. Hence bankers will complain. You’ll feel immediate political pain. Yet the benefits of higher capital standards, although very real, will occur over the long run and be less obvious than the costs. Raising capital levels will help protect the taxpayers, but the taxpayers won't know it. Moreover, in pressing weaker banks to shape up and in limiting the flow of credit to real estate, you may get blamed for causing problems that already existed. From the standpoint of your own self-interest, you're better off not raising capital standards. You can leave office popular. By the time banks get into trouble, you'll have a new job and your successor will have to shoulder the problem.

Similar incentives encourage too-big-to-fail treatment. Bailouts confer immediate, readily identifiable benefits. By contrast, the costs of intervention (such as increased moral hazard and potential for future instability) are long-term, diffuse, and less obvious. But you can leave those problems for another day and another regulator. You risk criticism whether or not you intervene. But on balance you run a greater risk of destroying your reputation if you let market discipline take its course. Unwarranted intervention may singe your career; a seemingly culpable failure to intervene will incinerate it.

Bank regulators need better incentives far more than they need new regulatory powers. Creating a unified regulator will make for a healthier set of incentives.

CONCLUSION

Now is the right time to fix the bank regulatory structure: now, while we're still keenly aware of the financial debacle; now, while special-interest pressure and bureaucratic turf struggles are less respectable than usual. Reform should promote efficiency, sharpen accountability, and help regulators withstand special-interest pressure.

Speaking from this table in 1994, Secretary Bentsen underscored the risk of relying on “a dilapidated regulatory system that is ill-designed to prevent future banking crises and ill-equipped to cope with crises when they occur.” He observed, in words eerily applicable to the present, that our country had “just emerged from its worst financial crisis since the Great Depression,” a crisis that our cumbersome bank regulatory system “did not adequately anticipate or help resolve.” He also issued this warning, which we would yet do well to heed: “If we fail to fix [the system] now, the next financial crisis we face will again reveal its flaws. And who suffers then? Our banking industry, our economy, and, potentially, the taxpayers. You have the chance to help prevent that result.”