June 1, 1989

ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

Rethinking the Regulatory Response to Risk-Taking in Banking

by W. Lee Hoskins

The record number of bank and savings and loan failures in this decade emphatically illustrates that the current financial regulatory system is seriously flawed. Its underlying shortcoming is that it ignores, and attempts to override, market forces. As we consider regulatory reform of the financial industry, we face two avenues: One road leads to reinvigoration of market principles and incentives to guide the industry. The other road leads to further reliance on the regulatory apparatus.

This *Economic Commentary* contends that the first course of action is the correct one and outlines the steps that will take us down that road. First, banking regulators must emphasize supervision rather than regulation. The essential difference between these two approaches lies in the nature of the limits placed on the discretion of bank management. Regulation amounts to placing unconditional limits on their discretion, implying that the judgment of bank managers cannot be trusted. Supervision implies conditional limits on their freedom of action, activated only when management actions threaten to impose costs on the insurance fund or on taxpayers. This approach presumes that management is competent unless they demonstrate otherwise.

Second, the current framework of multiple regulatory agencies offers a number of advantages over streamlined alternatives that have been proposed. This system should be preserved and fine-tuned, rather than discarded.

Third, the deposit-insurance system must be reformed so that the market plays a larger role in assessing and pricing bank risk. The current method of deposit-insurance pricing encourages bank management to take additional risks and substitute insured deposits for uninsured debt and equity. It reduces the incentives for insured depositors to care about the riskiness of their banks. Further, it leaves the tasks of monitoring and restraining bank risk-taking almost entirely in the hands of regulators.

In considering reforms to promote the health and efficiency of our financial services industry, the critical focus should be on revamping the current system of deposit-insurance pricing and coverage. These reforms should emphasize greater reliance on market forces and less reliance on the regulatory apparatus, while retaining the advantages of a multiple-agency framework.

Regulation and Its Costs

At present, we are essentially following the approach adopted nearly 50 years ago, amid the financial fallout of the Great Depression: the goal of a safe and sound financial system has been entrusted largely to a regulatory process, rather than to private decisionmakers operating in free markets. Regulators have attempted to achieve a strong financial sector by controlling the activities of certain classes of financial intermediaries, most notably commercial banks.

Numerous constraints on the discretion of bank management to undertake risky competitive actions were imposed mainly through acts of Congress. Controls on pricing, products, location, and balance-sheet composition were designed to prevent the failure of individual banks. Moreover, deposit

ISSN 0428-1276

liabilities were insured (up to a limit) to reduce the incentives for deposit-holders to withdraw their funds in the unlikely event that a failure occurred.

For several decades after the Depression, the financial system appeared to be relatively safe and sound. The supervisory and regulatory apparatus that was erected seemed to be an effective, inexpensive, and permanent bulwark against fears of chronic financial instability. The regulators appeared to be doing their jobs well, since bank failures were few in number and not costly. However, as the 1970s began, a confluence of forces—most notably volatile inflation and high nominal interest rates, along with a substantial decline in the costs of information processing and transmission—served to illuminate the substantial flaws and social costs of the existing system of bank regulation.

What have we learned from this experience of exclusive reliance on regulation? It should be obvious that using government regulation to achieve economic goals entails both substantial costs and a number of risks. One risk is that a regulatory system will not be as effective as desired, both when initially implemented and over time. Another risk is that regulation will have unintended, perverse effects.

The present system of bank regulation, which includes numerous constraints on the market mechanism, is inevitably costly. Some costs are highly visible and explicit: regulated institutions incur compliance costs, and regulators bear monitoring costs. Other costs are not so visible. For example, costs associated with restrictions on permissible activities can prevent economies of scale and scope from being realized, thereby raising the costs of regulated firms. Restrictions on activities, products, and location decrease the options available to consumers and artificially raise prices by limiting competition.

Regulatory barriers to competition may have a further subtle effect on the costs of regulated firms. Protection from competition reduces the incentives of regulated firms to minimize current costs. It also reduces their need and desire to seek out and adopt innovations that could result in lower costs in the future.

Regulation entails still other costs. Regulatory rules limit firms' ability to take certain actions, but do not eliminate management's desire to pursue profitable business opportunities. The lure of profits, combined with changes in technology, conducive economic conditions, and the existence of domestic and foreign competitors who are subject to different degrees of regulation, gives regulated firms the motive and the opportunity to avoid existing regulatory constraints. Inevitably, regulated financial institutions will search for substitute ways to engage in lucrative, prohibited activities. Such activity is costly, however, and even if successful, results in the inefficient provision of financial services. Hence, regulators are continually faced with a dilemma: acquiesce or add more regulation to plug the loopholes. The latter restarts the costly cycle.

In addition to the inevitable costs, regulation can have unintended, perverse effects. For example, regulatory limitations on the ability of commercial banks to diversify, both geographically and into additional lines of business, were designed to reduce risk by limiting competition and preventing bank involvement in activities where large losses could be incurred. Astute use of diversification by banks was presumably viewed as unlikely. The huge losses realized by banks with undiversified loan portfolios in the 1980s illustrate the misguided, unintentional impact of regulation.

■ Supervision Rather Than Regulation

If regulation is costly and cannot be relied on to produce the desired result, then what should be done? Certainly, a political and legal framework is indispensable for assuring individual liberties and property rights, and for setting the rules of the game within which markets operate. But detailed regulation should not be used to guard against the normal risks of a competitive marketplace. Such direct controls adversely affect long-term decision-making and inevitably hurt those they were intended to help. The examples are plentiful. Railroads, sheltered by rate-of-return regulation, eventually withered into near-complete decay. The U.S. steel industry, once protected from the rest of the world by a government-guaranteed price floor, soon became a world leader in inefficiency.

The same seems to be true for the banking industry. Banks have lost market share to less-regulated competitors in areas that they had long dominated, such as commercial lending, consumer installment credit, and retail deposits. In addition, the banking industry's profitability has been falling during the 1980s, reaching levels not seen since 1959.

A safe and sound financial system can be attained at a substantially lower cost if we rely less on regulation and more on supervision. This requires a sharp reversal in the attitude of government authorities. Rather than imposing unconditional limits on the discretion of bank management, or regulating their behavior, the authorities should conditionally cede discretion to bank management. That is, the authorities should let bank management manage.

A supervisory approach recognizes that regulation is costly; it also recognizes that bank management has the skills, information, and incentive to make optimum use of its resources, while bank regulators do not. The amount of discretion extended to management could vary across banks, depending on a number of factors, such as the supervisory authority's assessment of the quality of the institution's internal controls and management, the institution's current and expected financial strength as evidenced by its capital and earnings, and the size of subsidies attributable to the provision of the federal safety net.

The recent debate about the appropriate response to bank involvement in leveraged buyouts (LBOs) illustrates the distinction between these two approaches. Some people are urging that bank involvement in LBOs be regulated—restricted or precluded. These critics presume that bank management cannot accurately evaluate risk. Others argue that bank participation in LBOs can generate a number of benefits for banks, firms, and the economy. Proponents of a supervisory approach argue that bank management has substantial expertise in evaluating risks and should be free to take risks commensurate with expected returns. Happily, we have refrained from regulating LBO lending by banks, choosing instead to supervise.

The appropriate role of banking authorities in a supervisory function is to distill the existing body of regulations into a compact, effective set, and to monitor and supervise the behavior of firms under their jurisdiction with as little intrusion as possible. Ideally, the arrangement would closely resemble bond or loan covenants, which are designed to influence management behavior with minimal intervention. The amount of discretion granted in these arrangements depends on judgments about the capabilities of management and their resources.

Supervisory authorities need timely, accurate information to be able to identify and close troubled institutions as they become insolvent. Prudent use of closure will ensure that the costs of bank failures are not excessive and are borne by uninsured creditors and stockholders, not transferred to the insurance funds or to taxpayers. Government authorities need to ensure that depository institutions supply adequate, accurate, and timely information on their financial condition not only to the supervisor, but also to the public.

Depositors and creditors will thus have incentives to choose and monitor more carefully the condition of financial institutions. Information provided by supervisors will be a vital input to these decisions. In turn, information generated by markets, such as the rates that banks need to offer to obtain funds from depositors and creditors, will complement the information from the supervisory process.

■ Should the Regulatory Structure Be Changed?

The structure of the bank regulatory system in the United States is unique in a number of respects. Banks can choose to be regulated or supervised by one or more federal and state agencies, each of whom has different goals and incentives corresponding to differences in their authority and responsibilities. For example, a chartering/regulatory authority has the incentive to maintain or increase its constituency. To accomplish this, it might offer broader powers or prevent the closure of insolvent institutions. The failure of institutions could be interpreted by some as ineffectiveness on the part of the government authority. A deposit insurer has an incentive to protect its fund; consequently, if able, it may also prevent or delay costly failures.

Critics have persistently argued that the multiple-agency system is seriously flawed and largely to blame for costly and ineffective bank regulation. In particular, it has been charged that this structure is primarily responsible for the unwillingness or inability of regulators to promptly close institutions that are insolvent, resulting in higher costs for the insurance funds and taxpayers. The ability of banks in this system to alter their regulatory status also allegedly induces "competition in laxity," where regulators compete for constituents by relaxing their standards. The implication is that consolidation of regulatory, supervisory, and insurance functions into fewer, or perhaps even one, agency is a desirable and necessary change.

I disagree with this view. It is not clear that regulatory consolidation would result in improved, less-costly regulation. Given the inevitable incentives of the insuring agency to protect the insurance fund, it would be particularly dangerous to concentrate the chartering, regulatory, supervisory, and insuring functions in a single entity.

It has been alleged that closures would occur more quickly and that costs of failure resolution would be lower if the Federal Deposit Insurance Corporation (FDIC), the insurer, also had regulatory, supervisory, and closure powers. This was certainly not the case for savings and loan institutions where the federal insurer, the Federal Savings and Loan Insurance Corporation (FSLIC), and the regulator, the Federal Home Loan Bank Board, were combined in a single organization.

The FDIC, like any insurer, has incentives to maintain the value of its insurance fund and therefore might delay closures that would materially reduce the value of the fund. Indeed, in the recent past, both the FSLIC and FDIC have been strong advocates of forbearance policies. Further, existing and threatened litigation stemming from recent closure decisions indicates that regulators' actions to close troubled institutions more quickly are viewed by some as violations of individuals' property rights.[1] Thus, it is not clear that the FDIC acting independently can resolve failures any faster or at less cost than it does currently.

The structure of the regulatory framework would be less critical in a world where deposit insurance did not exist or was perfectly priced. However, given mispriced deposit insurance and the attendant need for regulation, the multiple-regulator system appears to work reasonably well and offers a number of advantages over proposed consolidated alternatives. In particular, competitive pressures can be introduced by having more than one regulatory option.

Each government authority has a different view on the best way to implement regulation due to various incentives, goals, and powers. Because each regulator's authority is vague and can overlap, disagreements can surface about the appropriate type and extent of supervision and regulation and also about the extent to which market discipline on regulated firms should be relied upon. This encourages healthy, ongoing public debates about the merits of alternative strategies and contemplated changes. A good example is the recent debate about minimum capital requirements between the Comptroller of the Currency and the FDIC. [2]

Such a forum may encourage regulatory innovation and experimentation. The existence of multiple regulators and the ability of a bank to change its regulator has fostered competition, creating pressure for regulators to lessen the impact of particularly burdensome, obsolete codes. For example, states are able and have been willing to expand securities underwriting powers for state-chartered, nonmember institutions, and this inevitably puts pressure on other regulators to follow suit.

The system of multiple authorities offers other benefits. Multiple regulators with overlapping authority might be more likely to discover problems within a holding company and to prevent problems at one unit from being transmitted to others. Another advantage of the present system is that the lender-of-last-resort function is not being exercised by either the chartering authorities or the insuring agencies. This arrangement, coupled with collateral requirements, reduces the probability that the Federal Reserve's discount window will be used to support insolvent rather than illiquid banks.

Finally, there is little evidence that "competition in laxity" has occurred in the present multiple-regulator system. In fact, historically, banks have not frequently changed their regulatory status.

While the current multiple-regulator framework has a number of desirable features, the structural configuration and distribution of powers and responsibilities need not be left totally unchanged. A number of alternative arrangements have been proposed over the years and might work as well as, or better than, the current system. At a minimum, there should be more than one agency chartering and regulating/supervising the activities of banks. In addition, regulated institutions should be allowed to choose their regulator. Given the inevitable incentives of the insuring agency to protect the insurance fund, it would also be wise to limit the insurers' involvement in both chartering and regulation/supervision.

It is particularly dangerous to vest all functions in a single agency. However, it might be desirable to allow the insurer to influence the choice of an institution's supervisor. Deposit-insurance premiums could differ depending on which supervisor was selected by a bank. Supervisors with records of early closure and other actions that protect the insurance funds would be associated with lower premiums. Finally, it is a good idea to have the lender-of-last-resort function performed by an agency that is not involved either in chartering or in the provision of insurance.

■ Deposit Insurance—The Need For Reform

To reap the benefits of a supervision-based system coupled with multiple government authorities, deposit insurance must be reformed. The current system of deposit insurance was adopted in 1933. By guaranteeing the transactions and savings balances of small depositors (originally limited to $2,500), deposit insurance removed the incentives for these individuals to participate in runs and, consequently, increased the near-term stability of the financial system.

Unfortunately, the way federal deposit insurance is priced and administered has created governmental subsidization of the risks undertaken by insured banks and thrifts. These subsidies reinforce the perverse incentives of the regulator and the regulated institutions.

The current method of flat-rate, risk-invariant pricing of deposit insurance shifts risk to the taxpayer. This subsidization of market risk allows financial institutions to seek out and pursue excessively risky business opportunities, which in turn justifies the use of regulation to guard against such instability. It is only a matter of time before institutions find ways around the constraint, aided by technological change and apathy toward market risk. This behavior forces the regulator to add further regulatory constraints, renewing the entire process.

Deposit insurance also discourages the government authority from closing poorly run, insolvent institutions. The extension of deposit-insurance limits (currently at $100,000), combined with the willingness of the FDIC and FSLIC to routinely guarantee the deposits of statutorily uninsured depositors and other uninsured claimants, has caused depositors and creditors—big and small—to become unconcerned about the financial health of institutions. Without the threat of market discipline, authorities can choose to push problems off into the future, hoping that they will heal over time. Therefore, although some headway can be made to correct the perverse incentives due to regulation and its implementation, attention must also be paid to the perverse incentives provided by deposit insurance.

Some policymakers have proposed deposit-insurance premiums that reflect market risk. While it is unclear whether risk-based premiums can be implemented easily and efficiently, it is feasible to alter the system so that a larger proportion of depositors and shareholders are exposed to a credible risk of loss. This creates incentives for private funds suppliers to assist regulators in their efforts to monitor and constrain banks' risk-taking. Monitoring might be more efficient and effective if done by people with funds at risk. If the deposit-insurance system is altered in this direction, the need for ancillary regulatory restrictions (for example, on activities and corporate organizational form) is correspondingly reduced. The recent adoption of risk-based capital requirements is an example of a movement in this direction.

A number of changes have been proposed to better align risk incentives. One alternative to risk-based deposit-insurance premiums would be more stringent limits on insurance and the enforcement of those limits in practice. Another reasonable proposal is some form of coinsurance. Still another possibility is higher capital requirements. These types of changes shift risk from the insurance agency and taxpayers to private individuals supplying bank funds. All of these changes would increase market discipline by prompting depositors, creditors, and shareholders to scrutinize more closely the financial condition of banks.

Conclusion

Recent events have raised questions about the safety and soundness of the financial system. Numerous, large, extremely costly bank and thrift failures have become commonplace in the 1980s. Additional regulation is not the appropriate response, however, because its costs, both explicit and implicit, are too high. Regulators cannot hope to completely and permanently constrain the actions of regulated firms, particularly when competitors are unconstrained.

However, given the existing federal safety net, some government intervention in the affairs of financial institutions is required. Supervision is preferable to regulation. Supervision appropriately treats banking as a business, leaving bank managers to pursue new opportunities and respond to market forces. The role of the supervisor should be to provide information to the management of financial institutions and markets and to close insolvent institutions promptly. A multiple-agency framework, rather than a consolidated one, is compatible with a system that relies more heavily on market forces and supervision. Furthermore, this framework is far less likely to foster "competition in laxity" when it is combined with less regulation and with deposit-insurance reform.

Reform of deposit insurance is the key. Without it, less reliance on regulation and more reliance on supervision and market discipline may not be feasible. And without reform, the consequences of excessive risk-taking will remain with the taxpayer.

Footnotes

1. Some examples of such institutions are First RepublicBank Corp, Dallas; MCorp, Dallas; Gibraltar Savings, Beverly Hills, CA; and Lincoln Savings and Loan Association, Irvine, CA.

2. The Comptroller of the Currency is the primary regulator and supervisor of national banks. The FDIC, in addition to providing deposit insurance, is the primary regulator and supervisor of state-chartered banks that are not members of the Federal Reserve System.

W. Lee Hoskins is president of the Federal Reserve Bank of Cleveland. The material in this Economic Commentary *is based on a speech presented to the Pennsylvania Bankers' Association annual convention in Baltimore, Maryland, on May 23, 1989.*

Recent Federal Reserve Bank of Cleveland publications on issues related to banking and deposit insurance are listed below. Single copies of any of these titles are available through the Public Affairs and Bank Relations Department, 216/579-2157.

Economic Commentary

Equity, Efficiency, and Mispriced Deposit Guarantees
James B. Thomson
July 15, 1986

Alternative Methods for Assessing Risk-Based Deposit-Insurance Premiums
James B. Thomson
September 15, 1986

Competition and Bank Profitability: Recent Evidence
Gary Whalen
November 1, 1986

Interbank Exposure in the Fourth Federal Reserve District
James B. Thomson
August 1, 1987

FDIC Policies for Dealing with Failed and Troubled Institutions
Daria B. Caliguire
and James B. Thomson
October 1, 1987

Financial Reform at a Crossroads
W. Lee Hoskins
December 15, 1987

Bank Runs, Deposit Insurance, and Bank Regulation, Part I
Charles T. Carlstrom
February 1, 1988

Bank Runs, Deposit Insurance, and Bank Regulation, Part II
Charles T. Carlstrom
February 15, 1988

Bank Lending to LBOs: Risks and Supervisory Response
James B. Thomson
February 15, 1989

Economic Principles and Deposit-Insurance Reform
James B. Thomson
May 15, 1989

Economic Review

FSLIC Forbearances to Stockholders and the Value of Savings and Loan Shares
James B. Thomson
3rd Quarter, 1987

A Comparison of Risk-Based Capital and Risk-Based Deposit Insurance
Robert B. Avery
and Terrence M. Belton
4th Quarter, 1987

Using Financial Data to Identify Changes in Bank Condition
Gary Whalen and James B. Thomson
2nd Quarter, 1988

Actual Competition, Potential Competition, and Bank Profitability in Rural Markets
Gary Whalen
3rd Quarter, 1988

Working Papers

The Use of Market Information in Pricing Deposit Insurance
James B. Thomson
WP 8609, August 1986

Deposit Insurance and the Cost of Capital
William P. Osterberg
and James B. Thomson
WP 8714, December 1987

Capital Requirements and Optimal Bank Portfolios: A Reexamination
William P. Osterberg
and James B. Thomson
WP 8806, August 1988

Federal Reserve Bank of Cleveland
Research Department
P.O. Box 6387
Cleveland, OH 44101

BULK RATE
U.S. Postage Paid
Cleveland, OH
Permit No. 385

Address Correction Requested:
Please send corrected mailing label to the above address.