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Rethinking the Regulatory Response to Risk-taking in Banking

W. Lee Hoskins, President
Federal Reserve Bank of Cleveland

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RETHINKING THE REGULATORY RESPONSE TO RISK-TAKING IN BANKING

My message today is a simple one. The underlying shortcoming of the present financial regulatory system is that it ignores, and attempts to override, market forces. As we consider regulatory reform of the financial industry, we are idling at a crossroads. 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.

I believe that the first course of action is the correct one, and today I would like to discuss my view of the regulatory system and the approach 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 the management of banking firms. Regulation amounts to placing unconditional limits on the discretion of bank management. This approach implies that the judgment of the management of the regulated firm 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 taxpayers. This approach presumes that management is competent unless they demonstrate otherwise.

Second, I believe that the current framework of multiple regulatory agencies offers a number of advantages over proposed, streamlined alternatives and 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. And it leaves the tasks of monitoring and restraining bank risk-taking almost entirely in the hands of regulators.

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. Specifically, achieving the social 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, the most notable example being commercial banks.

Numerous constraints on the discretion of bank management to undertake risky competitive actions were imposed mainly through acts of Congress. Controls were imposed on pricing, products, location, and balance sheet composition. These restrictions were designed to prevent the failure of individual banks. Moreover, deposit liabilities were insured (up to a limit) to reduce the incentives for deposit holders to run 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 appeared to be an effective, inexpensive, and permanent bulwark against the fears of chronic financial instability fostered by the experience of the 1930s. The regulators appeared to be doing their jobs well. 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, produced an environment in which the existing system of bank regulation could be seen as one containing substantial flaws and social costs.

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. There is the risk that a system of regulation will not be as effective as desired, both when initially implemented and over time. There is also the risk that regulation will have unintended, perverse effects.

The present system of bank regulation includes numerous constraints on the market mechanism and so 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. There are costs associated with restrictions on permissible activities that 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 the need and desire to seek out and adopt innovations that could result in lower costs in the future.

There are other costs of regulation. Regulatory rules limit the ability of regulated firms 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 subject to different degrees of regulation, give regulated firms the means, motive, and opportunity to avoid existing regulatory constraints. Inevitably, regulated financial institutions will search for substitute ways to engage in lucrative, prohibited activities. However, such activity is a costly endeavor. Even if successful, the end result is the inefficient provision of financial services.

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 supposed to reduce the riskiness of banks 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 illustrates the misguided, unintentional impact of regulation. Another well-known example of regulation with unintended, perverse effects is flat-rate deposit insurance. I will discuss this more fully in a moment.

Regulation, then, is costly and cannot be relied on to produce the desired result.

SUPERVISION RATHER THAN REGULATION

So what should be done? I do not think that government involvement in financial markets should be ended. To be sure, a political and legal framework is indispensible 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 decisionmaking, and inevitably hurt those they were intended to help. The examples are plentiful. Railroads, sheltered by rate-of-return regulation, eventually whithered 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 like 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.

I believe that 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 their 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 world where supervision is emphasized 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 as unintrusively as possible. Ideally, the arrangement would closely resemble bond or loan covenants -- private market arrangements that are designed to effectively influence management behavior with minimal restraints on their discretion. 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 taxpayers. Government authorities need to ensure that depositories supply adequate, accurate, and timely information on their financial condition not only to the supervisor, but also to the public. Depositors and creditors will have incentives to more carefully choose and monitor the condition of financial institutions. Information provided by supervisors will be a vital input to these decisions. In turn, information generated by markets in the form of rates 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 U.S. is unique in a number of respects. As you know, banks can choose to be regulated or supervised by one or more federal and state agencies. These agencies have different goals and incentives due 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, they 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, 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 costs of failure resolution would be lower if the Federal Deposit Insurance Corporation (FDIC), the insurer, also had regulatory, supervisory, and closure powers. The Federal Savings and Loan Insurance Corporation (FSLIC)/Federal Home Loan Bank Board experience indicates that this is unlikely. 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 (like those at First Republic, MCorp, Gibraltar Savings, and Lincoln) indicate that actions taken by regulators to close troubled institutions more quickly are viewed by some as violations of the property rights of individuals. Thus, it is not clear that the FDIC acting independently can resolve failures any faster or at less cost.

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 and the ability of banks to alter their regulatory status 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, inter-agency 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 (e.g., the recent debate between the OCC and FDIC about minimum capital requirements).

Such a forum may encourage regulatory innovation and experimentation. The existence of multiple regulators and the conversion option has encouraged regulatory competition, creating pressure for regulators to lessen the impact of particularly burdensome, obsolete regulations. For example, states are able and have been willing to expand securities underwriting powers for state-chartered, non-member 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 prevent problems at one unit from being transmitted to others. In this way, multiple regulators could serve as a useful double-checking device. Another advantage of the present system of multiple regulators 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 discount window will be used to support insolvent rather than illiquid banks.

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.

The multiple regulator framework should not be abandoned since it has a number of desirable features. However, the present 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 or better than the current system. At a minimum, there should be more than one agency chartering and regulating/supervising the activities of banks. 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 in either chartering or 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 transaction 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 regulatee in a controlled environment of regulation. What's more, deposit insurance justifies regulatory constraints and contributes to the regulatory dialectic.

The current method of flat rate, risk-invariant pricing of deposit insurance allows risk to be shifted to the taxpayer. This subsidization of market risk allows financial institutions to seek out and pursue excessively risky business opportunities. Institutions' participation in risky ventures justifies regulators use of regulation to guard against such instability. However, 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 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 threat of this market discipline, authorities can choose to push problems off into the future in hopes 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 risk-taking by bank management. 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 co-insurance. 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 more closely scrutinize 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. The costs of regulation, both explicit and implicit, are high. Regulators cannot hope to completely and permanently constrain the actions of regulated firms, particularly when competitors are unconstrained.

However, given the federal safety net that exists, 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. And, a multiple agency 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 such reform, 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.