Streamlining Bank Regulation: A Better Way

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The Treasury has proposed consolidating the federal supervision and regulation of banks and savings institutions into a single agency, in order to reduce the cost of bank regulation. The aim is laudable. But the design is flawed: It exposes the banking system and the economy to unnecessary risks, because it does away with important features of the current system that we cannot afford to abandon.

A major design flaw of the Treasury's approach is the elimination of the supervisory and regulatory role of the Federal Reserve. When the Fed was established, the Congress and the administration wisely recognized that direct oversight of banks goes hand in hand with the Fed's other responsibilities. The conduct of monetary policy, the administration of the payments system, and the ability to anticipate and respond to problems in financial markets -- all depend on the Fed's having an intimate understanding of banking and financial markets. Over the years, this bank regulatory experience has been indispensable to ensuring that the Fed has the up-to-date, in-depth knowledge of banking and financial markets that it needs. Today this front-

line experience is even more important given the level of sophistication and the rapid pace of innovation in domestic and international financial markets.

Relying on written reports and other second hand information from another agency is simply no substitute for the Fed's direct supervision and regulation--especially when the Fed has to mobilize its staff quickly to contain financial crises. Banks are an important channel through which the Fed responds to such situations. The Fed's direct oversight of banks establishes vital lines of communication and keeps them open. Deep involvement in bank regulation also gives the Fed the credibility that inspires confidence. The market's confidence in the Fed is crucial in containing the widespread uncertainty associated with crises in the financial markets. This dynamic certainly made the Fed's injection of liquidity far more effective in containing the fallout from the 1987 stock market crash, for instance.

Active involvement in bank supervision and regulation also is important to the Fed in carrying out its other functions. For example, developments in banking can affect the overall economy, which in turn can affect the Fed's monetary policy decisions. A recent case in point was the so-called credit crunch. In that instance, direct supervision gave the Fed a clearer and more timely understanding of the weakness in bank lending. The detailed knowledge gained through bank examinations allowed for a more prompt and appropriate response to the situation through monetary policy.

Moreover, as the nation's central bank, the Fed has certain advantages over other bank regulators, especially in the international arena. The Fed interacts frequently with the central banks of other countries on monetary policy and various financial markets issues. The international status and credibility of the Fed is an advantage in supervising foreign banks' activities in our country and U.S. banks' activities abroad, an advantage not shared by other banking agencies.

The Treasury proposal for a single federal super-agency has another very serious flaw, which could compromise bank regulation itself. Regulations intrude deeply into the operations of banks and thrifts, stipulating what institutions can do, and sometimes even how they may do it. As a result, mistakes in rulemaking or enforcement can be costly to the institutions and ultimately to their customers and the overall economy. The current system is a balanced sharing of authority among state and federal agencies. The checks and balances inherent in a system with more than one federal regulator help contain regulatory mistakes, while at the same time allowing scope for financial innovation. A single super-agency would seriously upset this balance. Any regulatory mistakes would affect the entire industry immediately. In addition, a federal colossus might be intransigent and unresponsive to changing conditions in dynamic financial markets. A sluggish federal regulator would be disastrous for banks and the economy.

The United States cannot afford to take the risks that go

along with the Treasury's proposal. Fortunately, we do not need to in order to streamline our regulatory system. The problem with the current system is not so much the number of regulators as it is the overlap of authority. Currently, a bank holding company that owns several different types of institutions could face as many as four federal regulators. In principle each regulator oversees a different part of the holding company, but in practice there is costly overlap that makes banking services more expensive.

I think we can both avoid the overlap and do better than the Treasury proposal by following three guidelines. The first, given the current scope of banking, is: "one bank, one regulator." Each firm in the industry-- a holding company, the banks and thrifts that it owns, and its nonbank activities--should be supervised by one federal banking agency. The second is: have two federal regulatory agencies. While each firm should face one federal agency, it should not be the same federal agency for all firms. Responsibilities could be divided up in ways to maintain the system of crucial checks and balances. The third is: retain the supervisory and regulatory role of the Fed. Ideally, this would include Fed authority over the largest banks as well as a mix of medium and smaller banks. Following these guidelines would yield most if not all the cost savings envisioned under the Treasury's consolidation plan and at the same time avoid the major shortcomings of the super-agency proposal. It's a better way.