Regulator's Incentives

Richard Scott Carnell

The financial debacle has caused worldwide pain and helped saddle Americans 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, and the complacency that comes with a long economic boom. But in banking the debacle was above all a regulatory failure. Bank regulators had ample discretionary powers to establish and enforce high standards of safety and soundness; they faced no insuperable regulatory gaps. They could, for example, have increased the required capital levels set during the 1980s instead of leaving those levels unchanged during two decades of prosperity and record profits. They could have used risk-based capital standards to constrain excessive exposure to the largest financial institutions, limit investments in the riskiest subprime mortgage-backed securities, curb other concentrations of credit risk, and require systemically significant banks to hold additional capital. Had regulators adequately used their 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.

The Treasury proposal and the House-passed Wall Street Reform and Consumer Protection Act of 2009 respond to this failure with more of the same—more discretionary powers without more accountability. They would leave unchanged the incentives that draw regulators toward laxity during good times. They would do too little to correct critical structural problems in our financial system. On the contrary, their approach would entrench and expand too-big-to-fail treatment and heighten moral hazard. In the name of financial stability, it would tend to exacerbate the cycle of boom and bust and magnify financial instability. Congress should act now to counteract perverse regulatory incentives and to correct the key defects examined elsewhere in this report. Structural problems demand structural reforms.

Regulators' Perverse Incentives

Bank regulators' failures partly reflect imperfect foresight, a frailty common to us all. But they also reflect incentives that discourage regulators from taking strong, timely action to protect bank soundness, the insurance fund, and the taxpayers. These perverse 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.

Regulators' perverse incentives arise largely from the nature of banking (a point to which I will return shortly) and the dynamics of interest-group politics. The benefits of overly risky banking are concentrated in banks' owners, managers, counterparties, and borrowers. These players have incentives to defend aggressive bank's practices against regulatory constraint. Taxpayers, by contrast, are numerous and unorganized and ordinarily pay little attention to bank soundness regulation. The organized, motivated few exert more political influence than the unorganized, uninformed many.

In any event, banking is by nature relatively opaque. Many bank assets lack ready markets. Valuing those assets entails judgment and is susceptible to manipulation by management. Outsiders accordingly have difficulty assessing banks' true financial condition. We as citizens have corresponding difficulty ascertaining regulators' effectiveness in keeping banks healthy.

Banks are also fragile. Their liabilities are more liquid than their assets: they use checking deposits to make five-year commercial loans. No bank holds enough cash to repay all depositors at once, nor could any bank that did so remain profitable. Banks fund their assets mostly with debt (e.g., $12 in liabilities per dollar of equity), which leaves banks acutely vulnerable to losses on their loans and other investments. Losing 9 cents per dollar of assets may exhaust a bank's equity. Moreover, regardless of their own financial condition, banks must pay deposits and other liabilities at par (i.e., 100 cents per dollar) or face closure. In sum, by the time a bank's regulator recognizes and decides to act against a bank's problems, the bank's prospects may already be impaired.

Mutual funds provide an instructive contrast. They invest in securities or other financial instruments traded on exchanges or in other ready markets. Market prices provide objective evidence of asset value. Funds that need cash can sell assets quickly without discounting the price. Moreover, funds raise money mostly if not entirely with equity. An investor who redeems her stock receives not the price she paid but her proportionate share of the fund's net assets. If asset prices have fallen since she bought her stock, she (not the fund) will bear the loss. This structure makes mutual funds more transparent and in important respects more resilient than banks.

Uncertainty about banks' financial condition makes regulators' jobs more challenging. It also creates leeway for regulators, consciously or unconsciously, to act in their own interests at the expense of the insurance fund and the taxpayers. If we as citizens could readily and reliably ascertain banks' condition, regulators who let banks deteriorate would soon harm their own reputations. But reality offers no such simple correctives. A bank can look healthy and report record profits even as it slides toward major losses. We may recognize the bank's problems only after the losses become obvious.

Given this uncertainty, regulators may stand to lose by taking resolute corrective and preventive action. Imagine yourself becoming a top bank regulator mid-

way through an economic boom and possible real estate bubble. Your amiable predecessor received high accolades from Congress and the industry. Banks look robustly healthy. But you have concluded that you should tighten supervision and phase in higher capital standards. You weigh the likely consequences of those steps. Banks will gradually become more resilient. We will ultimately have fewer bank failures, smaller insurance losses, and less risk to the taxpayers than we otherwise would have. Yet you may receive little credit for those achievements. When the boom ends, we will in any event have more failures than under your luckier but less vigilant predecessor. To the untutored eye, you will still look less successful. Few people will ever think of the problems you averted.

Meanwhile, your program will have immediate, readily identifiable costs. Banks will pare dividends and tighten lending standards. Their return on equity will decline as they hold more equity per dollar of assets. You will draw sharp criticism from bank trade associations, homebuilders, real estate developers, talk-show hosts, and members of Congress. They will accuse you of capriciously endangering jobs, housing markets, entrepreneurship, and the nation's prosperity. After all, conventional wisdom saw no danger, no reason for stringency. From the standpoint of strict self-interest, you would have fared better by going with the flow.

For regulators' reputations suffer less from problems that develop on their watch than from problems that become public on their watch. The careers of President Reagan's three chief thrift regulators sadly illustrate this pattern. The first, Richard T. Pratt (1981-83), pursued disastrous policies of deregulation and capital forbearance but left before their consequences became apparent. He became a partner at Goldman Sachs. The second, Edwin J. Gray (1983-87), initially followed Pratt's lax policies but later worked to rein in overly risky investments, restore capital discipline, strengthen his agency's examiner corps, and recapitalize thrifts' deposit insurance fund. His position became untenable when he lost the industry's political support, and he left to head a troubled thrift in Miami. The third, M. Danny Wall (1987-89), largely continued progress toward restoring regulatory discipline. But during his tenure the insurance fund's insolvency became too grave to deny. Although Wall had not caused the insolvency, he gained notoriety for understating it and left with his reputation in tatters. He suffered less for his own errors than because the bill for others' errors came due on his watch.

In sum, we have difficulty telling good banks from bad—until it's too late. We have difficulty telling good regulation from bad—until it's too late. Lax regulation wins more friends and plaudits than stringent regulation—until it's too late. Risky banks and their allies exert more political influence than taxpayers—until it's too late. These dynamics contribute to a stubborn reality underlying the regulatory failures of the past four decades: bank soundness regulation has no political constituency —until it's too late.

Regulatory Fragmentation Exacerbates Perverse Incentives

Our fragmented bank regulatory structure heightens regulators' perverse incentives. Four different federal agencies regulate FDIC-insured banks and their affiliates. The Comptroller of the Currency regulates national banks. The Federal Reserve regulates state banks that have joined the Federal Reserve System and most companies that own commercial banks. The FDIC regulates state banks not in the Federal Reserve System. The Office of Thrift Supervision regulates thrifts and their parent companies. The four agencies compete to attract and retain regulatory clientele. A bank can switch from one regulator to another by changing its charter or Fed membership.

Senator William Proxmire called this structure "the most bizarre and tangled financial regulatory system in the world." Federal Reserve Vice Chairman J.L. Robertson branded it "a happenstance and not a system." No other country has competing bank regulators. No other U.S. industry has competing federal regulators.

The crazy-quilt of overlapping jurisdiction and duplicative functions exacerbates bank regulators' perverse incentives:

- It encourages unsound laxity by setting up interagency competition and leaving regulators overly deferential to their bank clientele.
- It undercuts accountability by confusing members of Congress, reporters, and citizens (and sometimes regulators themselves) about which agency is responsible for what.
- It slows decision-making and can hinder action to prevent future problems. Interest groups can play off regulators against each other. A single stodgy, stubborn, or overly solicitous agency head can obstruct action, declaring, "if it ain't broke, don't fix it." Not surprisingly, the agencies work better when responding to present problems than when trying to head off problems.
- It divides authority over integrated banking organizations—corporate families in which banks deal extensively with their affiliates—among two or more agencies, each charged with supervising only part of the organization. In so doing, it blunts each agency's accountability and impedes the process of identifying and correcting problems.
- It leaves individual agencies smaller, weaker, and more vulnerable to special-interest pressure than a unified agency would be. It can also impair regulators' objectivity, as occurred with thrift regulators during the 1980s.

Regulatory fragmentation played a key role in the thrift debacle. Specialized thrift regulators acted as cheerleaders for the industry. When much of the industry became insolvent, those regulators balked at taking strong, timely action. Such action would have caused the thrift industry to shrink, forced fee-dependent thrift regulators to lay off employees, and ultimately raised doubts about the need for a separate thrift regulatory system. Regulators instead let insolvent thrifts remain open, grow aggressively, exercise risky new powers, and

ultimately impose even greater losses on the insurance fund and the taxpayers. But the record improves when we turn from thrift-only regulators to bank regulators who also supervised thrifts. Those bank regulators restricted troubled thrifts' growth and closed deeply insolvent institutions. At the state level, thrifts regulated by state banking commissioners failed less often and caused smaller insurance losses than thrifts with specialized, thrift-only regulators. At the federal level, thrifts regulated by the FDIC fared far better than those regulated by the thrift-only Federal Home Loan Bank Board.

Banking Statutes Impose Inadequate Accountability

Properly framed statutory standards can heighten regulators' accountability and counteract perverse incentives. Congress did employ such standards when requiring regulators to take "prompt corrective action" to resolve capital deficiencies at FDIC-insured banks. Such banks face progressively more stringent restrictions and requirements designed to correct problems before they grow large and in any event before they cause losses to the insurance fund. A regulator can accept an undercapitalized bank's capital restoration plan, and thus permit the bank to grow, only by concluding that the plan "is based on realistic assumptions, and is likely to succeed in restoring the institution's capital." If the bank's capital falls so low that the bank has more than $98 in liabilities for each $100 of assets, the FDIC must take control of the bank unless the regulator and the FDIC agree on an alternative approach that would better protect the FDIC. 12 U.S.C. § 1831o. These standards have teeth. They limit regulatory procrastination and provide clearer, more consequences for capital deficiencies.

Yet Congress often gives bank regulators broad discretionary powers without adequate rules, standards, and accountability. The Federal Reserve Board can permit a financial holding company to engage in any activity that the board believes is "complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally." 12 U.S.C. § 1843(k)(1)(B). This standard imposes no meaningful constraint. What lawful activity would inherently pose "a substantial risk to . . . the financial system generally." Such a risk might arise from operating nerve-gas pipelines, creating lethal computer viruses, or training aspiring hackers to cripple competing financial institutions' computers. Yet those activities would be illegal. The statute lets the Fed authorize whatever activities it pleases—an approach that makes sense only if Congress has little concern about the breadth of activities in which bank-affiliated firms can engage. Exceedingly permissive standards also apply when the Fed classifies activities as "financial" and thus permissible for financial holding companies.

Recommendations

- Congress should unify federal bank soundness regulation in a new independent agency. The agency would supervise all FDIC-insured banks and thrifts and their parent companies. Its governing board should include representatives of the Treasury, Federal Reserve, and FDIC. This unified structure would maximize accountability, curtail bureaucratic

infighting, and facilitate timely action. It would also help the agency maintain its independence from special-interest pressure. The agency would be larger and more prominent than its predecessors (in their role as bank regulators) and would supervise a broader range of banking organizations. It would thus be less beholden to a particular industry clientele (e.g., thrifts) and better able to persevere in appropriate preventive and corrective action. Moreover, a unified agency could more effectively supervise integrated banking organizations, including those whose unsound risk-taking helped fuel the recent financial crisis.

- Congress should prescribe clear, focused, realistic goals for the new supervisory agency, the FDIC as deposit insurer, and the Federal Reserve as lender of last resort.
- Congress should frame important statutes in ways that reinforce regulators' accountability and help them withstand pressure for unsound laxity. In so doing, it should consider the pressures and temptations regulators will face in administering the statute and the type of errors regulators would be most likely to make.
- Regulators should strengthen capital requirements. Bank soundness regulation has too often failed us, and the financial system has become riskier over the past several decades. Thus it makes sense to require banks to hold additional capital as a buffer against unexpected losses.
- Regulators should raise the capital triggers for prompt corrective action—triggers set low during the last banking crisis and not increased since. Higher capital triggers would reinforce incentives for banks to hold ample capital, better achieve the statutory purpose of avoiding or minimizing loss to the insurance fund, and help constrain regulatory procrastination.
- Both Congress and regulators should bear in mind the limits of regulation, particularly when faced with strong moral hazard. Regulators should work to restore market discipline on large financial institutions. Members of Congress, in overseeing regulators' performance, should insist on timely progress toward that goal.

Richard Carnell

Mr. Carnell, Associate Professor at Fordham Law School, specializes in the regulation of financial institutions and co-authors a leading textbook in the field. His interests include bank soundness regulation, affiliations between banks and other firms, and financial institution failure. As Assistant Secretary of the Treasury for Financial Institutions (1993-1999), he played a key role in securing legislation to authorize interstate banking and branching. As senior counsel to the U.S. Senate Committee on Banking, Housing, and Urban Affairs (1987-1993), he was architect and principal drafter of the FDIC Improvement Act of 1991, which tightened capital discipline on insured banks, required risk-based premiums, and ended for 17 years the practice of treating large banks as "too big to fail." He also helped develop the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, which reformed thrift regulation. He holds a B.A. from Yale University and a J.D. from Harvard Law School.

The views expressed in this paper are those of the author and do not necessarily reflect the positions of the Roosevelt Institute, its officers, or its directors.