Would Consolidating Regulators Avoid the Next Crisis?

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Homepage Synopsis:
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Introduction

Treasury Secretary Geithner and Congressional Democrats have called for ending competition between bank regulators, which they claim contributed to the crisis. This claim, however, has almost no evidence to support it, and considerable facts to the contrary. Washington needs to stop wasting precious time on pet peeves unrelated to the crisis, and turn its attention to fixing the underlying flaws in our regulatory system.

The narrative in Washington argues that competition among financial regulators allowed financial institutions to choose the weakest regulator, and also encouraged regulators to weaken their supervision and enforcement in order to attract more entities toward their charter. Hence the response of Democrat congressional leaders and the Obama administration calling for an elimination of both the Office of Thrift Supervision (OTS) and the Office of the Comptroller of the Currency (OCC), and their merger into a single "super" bank regulator.

Who gets to choose?

Before discussing the extent of actual competition among bank regulators, it is worth asking: "Who, among our nation's financial institutions can actually choose their regulator?" It may be easier to ask first, who cannot, and what role did they have in the financial crisis. Two institutions at the very center of the housing bubble were Fannie Mae and Freddie Mac. These two entities have no ability to choose their regulator. So whatever the reasons for their failure, we know charter-shopping was not among them. If one of the ultimate purposes of prudential regulation is to protect the taxpayer, then the likelihood that the American taxpayer will put up to $400 billion into resolving Fannie Mae and Freddie Mac – more than the total cost to the taxpayer of the almost 6,000 banks and thrifts that have failed since the advent of our national banking system – should demand that their reform take center stage in any plan to protect the taxpayer from future losses.

Beyond Fannie and Freddie, much of the financial crisis was focused on Wall Street, specifically among the investment banks, such as Bear Stearns, Lehman Brothers, and Merrill Lynch. Interestingly enough, these investment banks were also unable to choose their regulator. They had no choice but to subject themselves to supervision from the Securities and Exchange Commission (SEC). Even those broker-dealers that were part of a bank holding company, and subject to Federal Reserve supervision at the holding company level, were unable to choose a primary regulator other than the SEC.

So who can choose to switch regulators? First, there is the choice between becoming a thrift or a commercial bank. For thrifts, the primary regulator is the Office of Thrift Supervision (OTS). Thrifts may also be state-chartered. In the case of commercial banks, the choices get a little more interesting. If a commercial bank is nationally chartered, its primary regulator is the Office of the Comptroller of the Currency (OCC). A state-chartered bank, in addition to being regulated by the state banking agency, will also be supervised by the Federal Reserve, if it is a member of the Federal Reserve System ,and by the Federal Deposit Insurance Corporation (FDIC) if it is not a member of the Federal Reserve System and maintains federal deposit insurance. It is vital to keep in mind that any bank or thrift offering federally insured deposits, which since the demise of state-run deposit insurance, covers essentially all banks and thrifts, is subject to the supervision of the FDIC, if that entity wants to maintain federally-backed deposit insurance.

In order for charter-shopping (and its alleged "race-to-the-bottom" in supervision) to be a viable explanation for the recent financial crisis, then charter-shopping must also be a viable option for those entities at the center of the crisis. Viewing charter-shopping solely from a legal standpoint indicates that the statutory framework of federal financial regulation greatly confines charter-shopping to a narrow range of institutions. The simple truth is that the worst-performing US institutions at the very center of the crisis lay outside that narrow range, having no choice in their regulator.

But let us move beyond the statutory framework, for if the recent financial crisis taught us anything, it is that regulators can often find creative methods for going well beyond the letter of the law.

Competition as A Discovery Process

One of the implicit assumptions behind the "race-to-the-bottom" theory of multiple bank charters is that regulators, or politicians, know *, ex ante*, the appropriate form and substance that bank regulation should take. The argument, simply, is that it is a lack of will, or a response to perverse competitive incentives, rather than a lack of knowledge, which results in regulatory failures such as the recent financial crisis. Or as Professor Ernst Baltensperger, of the University of Bern, has argued with respect to capital regulation, the "race-to-the-bottom" analysis assumes "that all necessary ingredients to quantitatively determine the socially optimal capital requirements are known. [1]" The performance of the Basel standards during the recent crisis should force us to discard such an assumption. Should we really expect the "quants" at our regulatory agencies to forecast any better than those in the private sector?

As Friedrich Hayek so insightfully recognized, "competition is…first and foremost a discovery procedure." Hayek goes onto argue that:

"there is no pre-determined range of known or 'given' facts which will ever all be taken into account. All we can hope to secure is a procedure that is on the while likely to bring about a situation where more of the potentially useful objective facts will be taken into account than would be done in any other procedure which we know.[2]"

This insight applies to the substance and performance of regulation, as much as it does to the market process. If one has any doubts as to whether there is a disagreement over how best to regulate financial institutions, especially those considered “too big to fail”, one only need to watch any of the recent hearings and mark-ups occurring in the House Financial Services Committee. While politics certainly plays a role, more important are the very basic disagreements as to the interpretation of certain facts and causal relationships leading up to the recent financial crisis.

Of course, when one feels strongly about one’s position, and senses an urgent need for action, debate and discovery can appear more a nuisance than an asset. Who needs discovery when you already have the answers? Such an attitude characterizes the position of Treasury Secretary Timothy Geithner and his argument for regulatory consolidation. Instead of seeing the perspectives of Sheila Bair, John Dugan, John Bowman or Ben Bernanke as valuable insights into the regulatory debate, Secretary Geithner appears more intent on labeling these “dissenters” as simply protecting their turf. Having spent a number of years as staff on the Senate Banking Committee, it has very much been my experience that members of that Committee lack a deep knowledge and understanding of financial markets. Creating a single bank regulator, under the supervision of the Treasury Secretary, would deprive Congress and the public of a much needed diversity in views on bank regulation.

Let’s go to the Data

Ultimately, whether the ability of banks to choose their regulator leads to a “race-to-the-bottom” in supervision and enforcement is an empirical question. Unfortunately there is a not a large empirical literature on the question. Luckily however, there is one careful, peer-reviewed study by Professor Richard Rosen, at Indiana University, that asks this very question [3].

Rosen tested a number of hypotheses relevant to the present discussion. First, there is the possibility that banks choose a regulator with greater expertise in the type(s) of lending in which that bank specializes. For instance, banks specializing in consumer lending are more likely to seek a charter from the OCC, while banks that specialize in commercial and industrial lending are drawn toward the Federal Reserve, and those specializing in real estate construction choose the FDIC. And, of course, the OTS has long attracted institutions specializing in mortgage finance. Professor Rosen finds that a powerful predictor of whether a bank switches its charter is an increase in the type of lending in which institutions under that charter specialize. For example, an increase in a bank’s consumer lending activity is a good indicator of whether that bank will switch its charter to the OCC from another regulator.

Of course, specialization by regulators may not be in the public interest. Specialization could simply be an avenue for attracting additional charters, or regulators may choose to be especially “lenient” in that area of lending. Rosen directly tests this possibility by examining the risk profile of banks before and after they switch charters. His finding is that banks that switch charters saw little change in risk while showing significant increases in return, suggesting the switch results in an increase in efficiency for the bank’s operations.

In addition to Professor Rosen’s econometric analysis, it is useful, in gauging the extent of competition among regulators, to examine just how many institutions are changing their charters and in what manner they are changing charters. Part of the narrative presented by Treasury Secretary Geithner is an argument that the OTS has been the “weak link” in our regulatory system. Such a narrative would imply that the OTS would be witnessing a substantial number of institutions switching to the thrift charter, as well as the OTS gaining “market share” at the expense of other regulators. Secretary Geithner’s hypothesis is, however, not supported by aggregate trends in charter-switching. For instance, over the past ten years, from 1999 to 2008, there were 164 financial institutions that switched *from* the thrift charter and 119 that switched *to* a thrift charter representing a net loss of 45 institutions regulated under the supervision of the OTS [4]. This trend is even more exaggerated when judged by the value of assets represented by those charters. Institutions converting to a thrift charter during this time have assets of $223 billion, while those switching from a thrift charter held assets of $419 billion. If market share is an indicator of competitive success, then the OTS's loss of market share over the last decade should be a clear sign that the OTS was not the most competitive agency in terms of attracting entities to its charter. It is also worth noting that those institutions switching from a thrift charter represented only about 10 percent of federally chartered thrifts. While competition is most intense at the margin, there seems to be little evidence that charter switching is a prevalent activity among federally chartered banks and thrifts.

Although the actual level of competition among bank regulators appears quite low, the existing level may provide benefits both in motivating regulators and in allowing banks to sort toward regulators more able to enhance the efficiency of their operations. Competition can provide some check on abusive behavior by regulators[5]. There are few industries as heavily regulated as banking, with a degree of micromanagement almost unheard of in other sectors of a market-based economy. Banking regulation also differs from other forms of economic regulation in the US in that banks have much fewer due process protections that other regulated industries. Many decisions by bank regulators are exempt from judicial review to an extent unseen in other areas. Accordingly, allowing charter switching can provide regulated entities with some protection from arbitrary and capricious decisions on the part of regulators.

Competition can also help to reduce "shirking" on the part of regulators. A small body of literature has begun to model and test to what degree regulators prefer a "quiet life."[6] One manifestation of regulators wanting a "quiet life" is discouraging banks from having complex portfolios or making substantial changes in existing activities. While on some level, complexity and change demand the attention of examiners, complexity and change can also reduce the overall risk of a bank's portfolio. For instance banks may use credit default swaps to reduce the credit risk in their bond or loan holdings. Doing so, however, would require examiners to have some understanding of these instruments. In the absence of regulatory competition, it would be far easier for regulators to simply prohibit banks from entering into complex transactions that could reduce risk rather than exerting the effort to understand such transactions.

How Competitive is the "dual banking" system?

While the Obama proposal makes no mention of changing our dual banking system, commentators often point to this system as the real source of competition in our bank regulatory system[7]. As Henry Butler and Jonathan Macey have argued[8], however, there is substantial reason to doubt the claim that the dual banking system offers much in the way of competition.

Since the failure of the Ohio and Maryland state thrift deposit insurance schemes in the 1980s, there is essentially no viable alternative in the deposit-gathering business to procuring deposit insurance offered by the FDIC. The import of this fact is that regardless of an institution's charter, and its primary regulator, if that institution wants to participate in federal deposit insurance, it will have to abide by the rules of the FDIC [9]. While the focus of supervision by the FDIC is the protection of the deposit insurance fund, its rules on minimum reserves, asset and lending restrictions, and other prudential requirements impose a considerable amount of uniformity in regulation across lenders.

The FDIC is not the only federal regulator that imposes a degree of uniformity across state- chartered institutions. Under the Bank Holding Company Act, the Federal Reserve maintains considerable supervisory powers over the activities of any company maintaining a bank subsidiary. These powers extend to holding companies, regardless of whether the bank subsidiary is a state or national bank, or whether the subsidiary is a member of the Federal Reserve system or not. While the Bank Holding Company Act is not without its limitations, the powers it conveys to the Federal Reserve result in a considerable degree on uniformity in the regulation of state-chartered institutions.

Did the OTS miss the boat?

One of the rationales offered for consolidating regulators is the need to end the perceived failures of the OTS. This perception rests, in part, upon the observation that both AIG and Countrywide owned thrifts at the time of their failure. In addition, the failure of thrift IndyMac was one of the largest bank failures to date. Not long after came the failure of Washington Mutual (WaMu). Therefore, the OTS must have been the weak link.

However, both AIG and Countrywide acquired federally chartered thrifts late in the game; their failures were already “baked in the cake” long before they acquired thrifts. Their thrift subsidiaries were also very small parts of their balance sheets. And in neither case did their failure result from their thrift subsidiaries.

In relation to IndyMac and WaMu, the entities regulated by the OTS specialize in mortgage finance; hence it should not be surprising that in the aftermath of a housing bubble, those engaging in mortgage finance fail at a greater rate. More importantly, neither the failure of IndyMac or WaMu cost the taxpayer a dime. The market disruption from their failures was minimal.

Prior to the savings and loan crisis, when there really was a significant difference between bank and thrift charters, thrifts could not choose to maintain their current business model and also flip charters, yet that lack of regulatory competition did nothing to help avoid the S&L crisis.

Since the case for eliminating the OTS is weak, there is an easy solution to address concerns regarding charter shopping: require the FDIC to base deposit insurance premiums on the historical and expected losses by charter. One could also require the FDIC to base premiums upon the location of the bank as well. There’s no reason for the rest of the country to subsidize the risky behavior of California-based mortgage lenders.

The failure of OTS-regulated institutions may reflect more deficiencies in the nature of the thrift charter than poor supervision by the OTS. For instance, the core feature of the thrift charter, the qualified thrift lender test, requires thrifts to maintain at least 65 percent of their portfolio in housing-related or other qualified assets. Although some non-housing assets can be used to meet that test, it is clear from the structure of the charter that Congress intended for thrifts to be lenders heavily specialized in housing finance. Given the frequency and cost of housing bubbles in the US, Congress should instead re-visit the notion of directing so much of our financial system into housing. The worst outcome would be to eliminate the OTS but retain the thrift charter, for such would maintain the excessive concentration of lending going to housing while reducing the available regulatory expertise needed to manage that concentration.

International Experience

The recent financial crisis was not one solely confined to the United States. Financial institutions around the world failed. Additionally, many countries witnessed housing bubbles during the last decade. In several countries, such as Spain and Ireland, the size of the housing bubble exceeded that of the US.

One major difference between the US and other developed countries is presence of multiple bank regulators in the US. In fact, only three developed countries have multiple bank supervisors: the United States, Germany and Liechtenstein [10]. And only in the US is there any real level of competition between bank regulators. If this was a crisis driven by competition among bank regulators, then most of the world would have been spared.

Opportunity Cost of Reform

Perhaps the strongest argument against a consolidation of banking regulatory agencies is that the energy and effort required by Congress to draft and pass such legislation, comes at the expense of passing legislation that would actually minimize the frequency and severity of future financial crisis. While both Congress and the Obama Administration have expressed the belief that there is no trade-off, that Washington can do everything at once, the truth is clearly different. Although Congress often pretends that the basic laws and postulates of economics do not exist, Congress is not exempt from these constraints. As former staff on the Senate Banking Committee, I recall the effort involved in merging the Office of Federal Housing Oversight and the Federal Housing Finance Board into a single regulator. Getting all the pieces right will require substantial attention from both Senate Banking and House Financial Services. There are only a handful of staff on either committee with the expertise to competently craft such a bill. As there is a limited window of time to pass politically difficult reform measures, such as re-structuring Fannie and Freddie, the resources of Congress would be best spent on efforts other than regulatory consolidation.

Conclusions

One can almost set a clock by the pattern. The U.S. experiences a financial crisis, often driven by speculative activity in real estate, and many voices in Washington offer regulatory consolidation as a cure. This time has been no different. Unlike the last time in 1994, when the Senate Banking Committee alone held five days of hearings on the topic, we now have both rigorous empirical testing and high profile data points refuting a “race-to-the-bottom” theory of competition among bank regulators. The fact is that those institutions at the very center of the crisis had no say in the choice of their regulator. In addition other countries with consolidated supervision also experienced financial crisis. The one constant, however, across both countries in the recent financial crisis, and the US during its last banking crisis, is the role of speculative real estate bubbles. Both Congress and US financial regulators would be better served focusing attention on reducing the frequency of real estate bubbles than spending precious time re-arranging boxes on the regulatory chart.

[1] Baltensperger, Ernst, “Competition of Bank Regulators: A More Optimistic View,” *FinanzArchiv* 59(2003): 330-335.

[2] Hayek, Friedrich, Law, Legislation and Liberty, Vol. 3. University of Chicago Press. 1979.

[3] Rosen, Richard, “Is Three a Crowd? Competition Among Regulators in Banking,” *Journal of Money, Credit and Banking* 35, #6(Dec. 2003): 967-998.

[4] Bowman, John, Testimony before the Committee on Banking, Housing and Urban Affairs, United States Senate, August 4, 2009.

[5] Greenspan, Alan, Testimony before the Committee on Banking, Housing and Urban Affairs, United States Senate, March 2, 1994.

[6] Berger, Allan, and Timothy Hannan, “The Efficiency Cost of Market Power in the Banking Industry: A Test of the ‘Quiet Life’ and Related Hypotheses.” *Review of Economics and Statistics* 80(1998): 454-465.

[7] Scott, Kenneth, “The Dual Banking System: A Model of Competition in Regulation,” 30 *Stanford Law Review*. 1977.

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[9] Weinberg, John, “Competition Among Bank Regulators,” Federal Reserve Bank of Richmond *Economic Quarterly*, 88/4 Fall 2002.

[10] James Barth, Gerard Caprio and Ross Levine, Rethinking Bank Regulation: Till Angels Govern. Cambridge University Press. 2006.