Want Simpler Regulation? Try Simplifying Your Bank First

By FDIC Vice Chairman Thomas M. Hoenig

Prior to the recent financial crisis, there was an extended period when governments and policymakers embraced the idea that markets could best police themselves and discipline financial firms' behavior, arguing that regulation was an impediment to achieving higher, more sustained growth. I strongly support markets as the best means to raise national income. However, supporters of financial deregulation failed to first acknowledge and adjust for the fact that the financial industry was no longer subject to the discipline of the free market. Government protections compromised the market's effectiveness in policing itself and individual firms.

Within this context it is concerning to learn of a renewed effort to change the regulatory structure, but not the structure regulated, which contributed so importantly to the crisis. Some CEOs of the largest banking firms and their lobbyists have pleaded that there are too many supervisors.[i] They often show a spider web-like chart that they say demonstrates the complexity and inefficiency of the regulatory structure. While I suspect a set of recommendations giving these companies what they want will be announced soon, adopting them will not strengthen the system and would distract from the real issues needing attention.

By comparison, the regulatory agency structure is hardly more complex or confusing than that of the firms and the activities being supervised. The financial industry with government-supported risk taking has been permitted to increase to a size and level of complexity that has become unmanageable; where weak controls failed to prevent recurring violations of laws and where outsized risks resulted in weak balance sheets and massive failures and bailouts.

Collapsing the regulatory agencies into one new super agency will not change these outcomes nor result in an improvement in regulatory performance as the emerging bureaucracy would be swallowed in its own quicksand of diseconomies of operations and bureaucratic impediments. Perhaps even more concerning, a single agency would increase the ease and likelihood of regulatory capture. Multiple agencies focused on specific goals create a system of checks and balances that allow regulators to confer as well as second guess each other. As any good bank examiner knows, skepticism is healthy.

I suggest, therefore, that the real issues to be addressed are the complexity of the firms supervised and the quality of the supervisory process.[ii] Almost certainly the demands for bank supervision are going to increase as governments, rather than private capital, serve as the backstop protecting depositors and creditors from loss should a bank fail. The incentives to take advantage of this public backstop – that is, to operate with too little capital and to engage in hedge-fund like activities without all creditors sharing the risk -- overwhelm the market's ability to discipline these players. To mitigate this effect there needs to be emphasis on better supervision.

The priority should be, first, improving the quality of oversight.. The backbone of quality supervision comes from the corps of professional staff at each agency trained in financial supervision, with careers built on knowledge, experience and avoidance of conflicts of interest. While there is value in having leaders with outside experience, there should be a greater share of agency leadership rising from an experienced professional corps.

Effective supervision requires that commissioned examiners systematically assess a bank's asset quality, liquidity, operations, and controls necessary to judge its risk profile, balance-sheet strength, and management. To declare confidence in a system without systematically examining individual firms within the system is disingenuous and dangerous. It is detrimental to the safety and soundness of the financial system that for the largest banking firms, annual full-scope examinations have been de-emphasized in favor of targeted reviews, model validations, and the use of stress tests, which rely too often on self-reporting. These activities are useful, but they are limited in scope. They have been adopted because the largest insured banks are thought to be too large and complex for full-scope examinations. However, statisticians have long been designing sampling methodologies for auditing a firm's assets, providing reliable estimates of their condition and at an affordable cost.

Finally, there is too little transparency in the regulatory process that impedes the return of the financial industry to greater market discipline. This includes the need to communicate regulatory matters more clearly to all interested parties. Improvements in this area would range from timely disclosure of supervisory information by individual institutions[iii]; to clearer, more easily understood reporting of numbers on balance sheets[iv]; and fuller, more timely public reporting on agency officials' views, votes, decisions and rationale for delays.

Allowing the financial industry to be highly complex using government support is the largest impediment to achieving a more safe and sound system. To attempt to effectively supervise today's financial industry requires more professional supervisors in agency leadership, examining all manner of banking firms, and increasing transparency in the regulatory process. Any proposal that weakens rules or consolidates regulatory agencies without attention first to the conflicted structure of the industry and the quality of supervision is a distraction. In the meantime, real weaknesses in the financial system remain.

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[i] Comments by Jamie Dimon: http://www.businessinsider.com.au/jpmorgan-jamie-dimon-letter-chart-2012-4

Comments by Michael O'Neill: http://blogs.wsj.com/moneybeat/2014/10/13/citi-chairman-oneill-too-many-banking-regulators/

[ii] "Financial Supervision: Basic Principles"
https://fdic.gov/news/news/speeches/spmarch0215.html

[iii] "Should more Supervisory Information Be Publicly Disclosed?"
http://www.kc.frb.org/speechbio/hoenigpdf/HoenigDiscloseSpeech5-8-03-2.pdf

[iv] Global Capital Index
https://fdic.gov/about/learn/board/hoenig/capitalizationratios4q14.pdf