



**The Jerome Levy Economics  
Institute of Bard College**

Public Policy Brief

# **The Limits of Prudential Supervision**

Reorganizing the Federal Bank  
Regulatory Agencies  
*Bernard Shull*

Introduction  
*Hyman P. Minsky*

**No.5/1993**

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## Preface

The issue of financial instability of the U.S. economy has been in center stage at least since the beginning of this decade, if not earlier. The blame has been attributed to a number of factors, among which the complexity of the structure of the banking sector as it relates to chartering, regulation, supervision and deposit insurance, and its role in monetary policy, is prominent. The S&L debacle and the erosion of the capital base of even the healthiest of commercial banks at the end of the decade of the 1980s provide but a confirming need to revisit the matter of banking reform.

The reform plan proposed by the Department of the Treasury in 1991 resulted in the enactment of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), whose core feature is to compel regulators to intervene when a bank's capital is impaired. The cheers for the prompt corrective action that FDICIA ensures by pushing bad banks out of business certainly dispirit those who believe that regulation is a matter of judgment and others who warn that shutting down a capital-impaired bank might prove costlier than bringing it back to health. These views notwithstanding, FDICIA, along with the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989,

laid, according to a consensus of academicians and lawmakers, the foundation on which the reorganization of the banking sector is to be built. A restructured banking regulatory environment must address the competence of the regulator and banker, the sophistication of tomorrow's markets and financial innovations, and the assumption that these cannot be regulated by yesterday's regulations; and finally, the new structure must engender confidence, above all else.

Since its inception, The Jerome Levy Economics Institute has been interested in the issues of financial structure and its relationship to the development of our economy. The essay by Professor Bernard Shull and the proposals he advocates therein are yet another contribution to the Institute's ongoing research program on "Reconstituting the Financial Structure," under the direction of Distinguished Scholar Hyman Minsky. We are very pleased that Dr. Bernard Shull has chosen the Institute's *Public Policy Brief* series to present his analysis of the problems afflicting the banking industry, along with a set of proposals to address them.

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*Executive Director*

May 1993

# Introduction

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*Hyman P. Minsky*

From the 1960s, when he was the research director for the Federal Reserve Board's monumental *Reappraisal of the Discount Mechanism*, through his experience as Chief of the Banking Markets Section of the Federal Reserve, to today as an academic scholar, Bernard Shull has been a serious student and perceptive commentator on bank regulatory matters and the structure of banking and financial markets. The theme of his paper is summed up in five words: the limits of prudential supervision. In Shull's view supervision needs to be a part of any financial structure, but it should not be relied upon to transform the financial relationships of a modern capitalist economy, which are inherently prone to malfunctioning, into a mechanism as precise as the best of watches.

As Professor Shull points out, a standard response in the United States to a rash of bank and financial institution failures has been the reenforcement of bank and financial institution supervision and regulation. As Shull notes, this reaction reflects an implicit theory of bank crises: "Bank crises are due to bad bankers." Our experience in this current cycle of banking and financial turmoil is but

another example of this tendency: These bad bankers may either be thieves or just incompetent.

The legislative response to the rash of financial failures since the mid-1980s has been consistent with the "bad bankers" theory of banking system malfunctioning. Congress's response to the crisis has increased the power and the number of regulators. The theory is that more and more powerful regulators would presumably prevent the wholesale failure of banks and S&Ls.

The reform of the regulatory process in response to the Treasury's losses in validating the deposit insurance commitment culminated in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which embodied a seemingly precise calculus of the status of a bank and the doctrine of prompt corrective action by the regulatory bodies.

As Shull emphasizes, the bad bankers theory that underlies FDICIA assumes away the possibility that the occasional development of crisis-prone financial structures reflects a deep characteristic of our economy, and that it may not be worthwhile to constrain the developments that periodically make banking and other financial relations fragile. This is so because the problems in banking arise after a period of exuberant economic performance: The tradeoff between longer periods of exuberance and stagnation versus shorter periods of exuberance and stagnation may well be that the benefits of exuberant performance outweigh the costs of stagnation. If this is true, the proper role of government and central banking would be to take the exuberance, but contain the damage that the ensuing increased instability would yield.

Shull's positive recommendation is to replace the separate regulatory agencies for different categories of banks with a *consolidated federal regulatory agency* that is coordinated with the monetary policy agency. The idea of having separate and autonomous regulatory and supervisory authorities for different categories of financial and depository institutions has tended to create regulation constrained by a competition for the custom of the regulated. Only a unified agency can fully do the task of supervising our complex system.

Furthermore, Professor Shull emphasizes that the supervisory and the regulation generating agency should not be divorced from the organization responsible for monetary policy: The Federal Reserve needs to be involved in formulating regulatory policy, and needs to know the results of *regulations and of monetary policy upon the viability of the regulated units*.

From 1979 to 1981, an episode of practical monetarism forced the Savings

and Loan Associations into a negative net worth position because their assets went to a sharp discount from their face value as market interest rates rose to an unprecedented level. This negative net worth was evident in a mark-to-market valuation of longer-term mortgage portfolios immediately after the rise in interest rates. Subsequently, in this period of penal interest rates, the net worth of the thrifts went below zero as the losses accumulated on carrying their portfolios of low rate mortgages at the market rate on liabilities.

If the Federal Reserve had the responsibility for supervising and examining the S&Ls, it would have been clear in 1979 that anything but a very short period of very high interest rates was an untenable policy posture: The mark-to-market valuation of assets clearly showed such a policy was bankrupting the thrifts. This first crisis in the thrifts was not a crisis due to nonperforming assets, but due to the duration of the interest rate inversion and the resulting explosion of long-term rates. The issue that the Federal Reserve would have had to face in 1979-1980, if its responsibilities had been broad rather than unduly narrow, was "Need we bankrupt the thrifts in order to contain inflation and sustain the value of the dollar on the international exchanges?" With hindsight, the deal in 1979 was poor: The costs in the 1990s of the monetary policies of 1979-1981 are perhaps much higher than was contemplated in 1980 or 1981.

If the monetary authorities were knowledgeable about the potential losses to the mortgage-holding institutions of a protracted regime of high interest rates, they would have moved to a flexible interest rate mortgage. However, the connection between the nature of the instruments held by financial intermediaries and the stability of the financial system has not penetrated the policy-making authorities. As a result of the current drop in interest rates, a great deal of refunding and refinancing of mortgages is taking place. The refinanced mortgages are predominantly fully amortized fixed rate, long-term mortgages (thirty years seems common). But the proliferation of such mortgages means that even a small rise in the relevant interest rates will knock out the equity of many organizations that lever to buy mortgages.

Bernard Shull's views on how to organize regulation—and the domain in which we can expect financial institution regulation—endeavor to have a positive impact upon our economic life.

# Reorganizing the Federal Bank Regulatory Agencies

*Bernard Shull*

Experience over the past decade is consistent with a long history of repeated banking difficulties that indicate supervision and regulation are not reliable techniques for sustaining the safety and soundness of banks. Nevertheless, repeated reforms, including the most recent ones, have largely been directed at augmenting bank supervision and regulation. In the past, such reforms have invariably been disappointing.

A principal reason for repeated disappointments has been failure to effectively address a number of systemic problems that have contributed to the repeated difficulties. Several can be identified, including an intractable economic problem and the growth of opportunistic behavior. A key institutional failure has been the fragmented federal regulatory structure. Among other things, it impedes regulatory planning, undermines the legitimacy of supervision, and makes it nearly impossible for the regulatory agencies to deal effectively with important systemic problems.

In Section I, systemic reasons for bank regulatory failure are briefly discussed. In Section



II, the role of the fragmented system in impeding efforts to deal with these issues is evaluated. The inadequacy of recent and proposed reforms is reviewed in Section III, while Section IV outlines a proposal for regulatory reorganization.

The proposal is for a unification of the federal bank regulatory agencies that currently have authority over competing depository institutions. The reorganization would follow a "functional subsidiary" model integrating monetary policy and deposit insurance authority, along with conventional regulation and supervision. Such integration is desirable, in and of itself, and would constitute a first step toward dealing with the systemic problems that have plagued the banking system. It might be accomplished through modification of the existing Federal Reserve System or in a new organization.<sup>1</sup>

## **I. SUPERVISORY AIMS AND SYSTEMIC REASONS FOR BANKING PROBLEMS**

The aims of supervision are typically specified as:

- protecting depositors, and/or
- protecting the insurance funds, and/or
- protecting the payments mechanism and/or
- protecting the money supply, and/or
- assuring that banks abide by laws that constrain the private use of their resources (e.g., the Community Reinvestment Act)

In general, each of these objectives may be viewed as involving a public function that banks perform.

While it is often said that it is not the purpose of supervision to keep banks from failing, these functions cannot be served by failing or failed banks, particularly if problems are system-wide. It is understandable, then, that supervisors are not simply concerned with closing insolvent banks, but also aim at sustaining banks as viable institutions. It is incumbent on them to explain why banks fail when they do.

Mismanagement as a cause of bank failure has been a recurrent theme [for an early example of the incipient "supervisory attitude," see Hammond, 1957, p. 201]. It has emerged repeatedly in studies by supervisory agencies in a succession of banking problems and crises over the last 70 years

(Friedman & Schwartz, 1963, pp. 269-70 and 358-59; Comptroller of the Currency, 1930, pp. 307-321). Walter Spahr epitomized the "supervisory attitude" when he wrote that "it is probably not possible to separate (the)...failures due to incompetent management from those due to local business depressions since it is the purpose and test of good bank management to avoid the effects of local financial depressions" (Spahr, 1932, p. 220).

In the mid-1970s, the reemergence of large bank failures evoked the traditional supervisory response. The federal banking agencies pointed to inept management and/or fraudulent practices as the principal cause (*First Meeting on the Condition of the Banking System*, 1977, pp. 1022-1025, 1077-1081, 1154-1167; FDIC, 1984, p. 13). In the late 1980s, the Comptroller indicated a "long-held belief" that bank management and boards of directors bear ultimate responsibility for bank problems that were the cause of most bank failures (Comptroller of the Currency, 1988, p. 1).

It is a small step from identifying management deficiencies as the principal cause of bank failure to finding that supervision needs to be augmented and improved. The currently active federal agencies provide a living historical record of the continuing efforts to provide such improvement. An explicit purpose of the Federal Reserve Act of 1913 was "to establish more effective supervision of banking in the United States." The massive bank failures of the early 1930s were attributed by many to both inadequate bankers and inadequate supervision. "Chief reliance has...been placed on bank examinations....In many cases, these examiners were less qualified for their jobs than the bankers were for theirs" (Gephart, 1935, p. 84). The measures required to remedy the "constitutional weaknesses" of the system, as seen by the Senate Banking Committee in reporting the Glass Bill in May 1933, have a familiar ring. They include increased capital requirements, stronger supervision, restriction of investments, the "truthful" valuation of assets, and, of course, deposit insurance (Senate Banking Report, 1933, p. 11).

Comprehensive banking reform, traditionally including augmented and improved supervision, has typically evoked a transcendent, and in retrospect, unwarranted optimism. The Comptroller of the Currency announced in 1914 that, with the new Federal Reserve Act, "financial and commercial crises, or panics...seem to be mathematically impossible" (Comptroller of the Currency, 1914, p. 10). Seventy-five years later, confronting the S&L disaster with yet another comprehensive reform—the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)—the Secretary of the

Treasury (Nicholas Brady) proclaimed "two watchwords guided us as we undertook to solve this problem: Never Again" (Brady, 1989, p. 1).

The S&L debacle of the 1980s, the high rate of commercial bank failure over the last decade, and the resulting depletion of the deposit insurance funds are indicative of another supervisory and regulatory failure.<sup>2</sup> Again, bankers and supervisors can and have been blamed. And the reforms to date, as discussed below, are indicative of this conventional wisdom.

As in most cases of repeated failure, we are better served by looking for systemic problems. At least several can be identified, including an economic problem (the effects of monetary surprises and exogenous shocks) and at least two institutional failures (opportunistic behavior among banking organizations and a fragmented regulatory structure).

#### **A. Monetary Surprises and Exogenous Shocks**

Unanticipated changes, whether emanating from sudden and drastic shifts in monetary policy (monetary surprise), or from exogenous shocks to bank-sensitive sectors and markets, may produce an escalation of pressure to which banks are unable to adjust quickly.<sup>3</sup>

During a long period of expansion, then, bank managements' assessments of the probability of "shocks" tends to be biased downward. Banks tend to take greater risks than an objective assessment, if such were possible, would warrant. Indeed, competition is likely to require that banks take greater risks than is warranted (Guttentag & Herring, 1986, pp. 2-4). In the late 1960s, Minsky referred to this phenomenon as "the economics of euphoria," and, more recently, Guttentag and Herring have labeled it "disaster myopia" (Minsky, 1971, p. 100-103; Guttentag & Herring, 1986, pp. 3-4).

The onset of a shock due, for example, to the inability of one or more large banks to replace volatile liabilities (Continental Illinois, 1984; Bank of New England, 1990) may leave many other banks excessively exposed. A shock, with similar policy implications, may be generated by severe monetary restraint to control inflation that abruptly elevates market interest rates (1979-1982). Threatened with insolvency, banks are likely to take greater risks, and doing so is likely to result in higher rates of insolvency (Golbe & Shull, 1991; Barth, Bartholomew & Labich, 1990).

The problem implies that bank supervisors need to be aware of developing fragility and of the growing vulnerability of banks to both monetary surprise and other shocks during expansions. But traditional supervision has

focused on identifying weak banks and correcting their weaknesses. It has not focused on identifying vulnerable banks and leaning against their fragility (Minsky, 1975; Guttentag & Herring, 1988, p. 602). There is also some evidence that regulators are afflicted by the same perceptual problems as bank managements (Guttentag & Herring, 1986, p. 33; Peterson, 1977, pp. 27-28).<sup>4</sup>

### B. Opportunism

In recent years, there has been a substantial increase in insider abuse and criminal misconduct in banking.<sup>5</sup> The legislative response has been to establish more extensive supervision and harsher penalties.

Widespread insider abuse and criminal misconduct constitutes a substantial burden on supervision. Like any form of appraisal, supervision is simpler when those being appraised recognize the legitimacy of the evaluation, believe it is of benefit to them, view themselves as participants with common interests, and generally govern their institutions with an attitude of "stewardship."<sup>6</sup> It is more difficult when those being appraised are intent on distortion and obfuscation. There has, from time to time, been a sense of stewardship among bankers that has been encouraged by supervisors.

The upsurge in misconduct can be viewed as an institutional failure. There has been no definitive study of the causes for an increase in misconduct in banking.

### C. The Fragmented Regulatory Structure

The problems created by a fragmented federal bank regulatory system have long been under discussion. Unification of federal bank supervision was proposed in Congress as early as 1919, again in the 1930s, and on numerous subsequent occasions (Robertson, 1966, p. 686; Horvitz, 1982; *Blueprint for Reform*, 1984, pp. 27-33; *Treasury Report*, 1991, pp. IX-6-IX-8, XIX; and Shull, 1993).

A decisive critique of the current regulatory agency arrangement was substantially complete by the end of the 1970s, and there was both anecdotal and empirical support for many of its shortcomings (Robertson, 1966; Hackley, 1969; and Lapidus et al., 1980).

Among other things, the current system produces overlaps of responsibility and duplication of effort that result in excessive cost either through redundancy or in efforts to divide responsibility and coordinate; and it imposes

differential costs on competing depository institutions. It has also generated agency conflict that has undermined supervisory discipline and/or imposed excessive burdens on banks (*Blueprint for Reform*, 1984, p. 29, note 16; Shull, 1980; Huston, 1985; Hackley, 1969). Differential regulatory environments induce competing depository institutions to seek the most attractive regulatory regime, permit escape from supervisory restraints imposed on individual institutions, and tend to erode regulation—in other words, a competition in laxity (Burns, 1975).

Of particular importance, problems have been solved inefficiently or remained unsolved because the agencies have difficulties in “sharing responsibility...problems of interagency coordination may...(undermine) confidence in the financial system” (*Blueprint for Reform*, 1984, p. 31). This inability implies constraints on strategic policy, for which a number of examples are available (see Shull, 1993, p. 100).

Finally, the existence of multiple agencies with overlapping and partial responsibilities obscures accountability (*Treasury Report*, p. XIX-4). Responsibility can be shifted or, at worse, diminished by sharing.

Two principal arguments have been made in favor of the existing structure. First, that a fragmented system imposes checks on arbitrary government authority. And second, that competition among regulators promotes experimentation, and erodes anticompetitive restrictions (see Scott, 1979; *Treasury Report*, Ch. XIX). But developments in recent years have strengthened the critique of the existing arrangements and undermined their defense.

In the 1980s, differentially permissive federal and state regulation of S&Ls provided a morbid illustration of the destructive regulatory competition and differential cost problems. It is noteworthy that excessively lax S&L regulation in the early 1980s led some commercial banks to become S&Ls (Isaac, 1984, pp. 1667-68). Forbearance for insolvent thrifts, and the relatively high rates they were willing to pay for deposits, injured not only solvent thrifts but also commercial banks (Brumbaugh, 1988, pp. 70ff.).

The case for unification has become increasingly persuasive in recent years. With an intensification of competition, differential regulatory costs have assumed even greater importance, made confusion generated by supervisory overlaps less acceptable, and timely policies to assist bank adaptation to rapidly changing financial markets critically important. Global banking and international regulatory agency deliberations (e.g., to establish uniform capital standards) place new demands on agency coordination. And, in light of

recent debacles, regulatory agency accountability has become even more essential.

Arguments for a fragmented regulatory system may have been more persuasive when there were more anticompetitive regulations to erode. With interest rate restrictions on deposits eliminated—and branch banking and activity restrictions in the process of elimination—the benefits of further erosion are, for the time at least, dubious.

Finally, it is now clear, if it was not always, that the “checks and balances” afforded by multiple agencies are just one of several types of constraints. Others that constrain regulatory agencies include industry pressure, litigation, and congressional oversight. For example, the transfer of regulatory authority from the Federal Home Loan Bank Board (FHLBB) to the Office of Thrift Supervision (OTS) was justified by evidence that the FHLBB, an “independent” agency with sole federal authority over S&Ls, had been excessively “checked” by industry and congressional pressure, and needed to be “insulated” (Greenspan, 1989, p. 6).

## **II. THE FRAGMENTED REGULATORY SYSTEM AND SYSTEMIC PROBLEMS**

The difficulties endured by federal agencies in sharing responsibility implies a diminished capacity. Important policies developed at any one agency may conflict with those of the others and, consequently, be frustrated. It is, moreover, unlikely that agencies will confront issues involving the development of policies likely to be frustrated. Consequently, coming to grips with important policy problems, such as the hazards of exogenous shock and monetary surprise, and constraining opportunism is seriously hampered by fragmentation.

The way in which important issues can be ignored by the regulatory agencies is characterized by the “too-big-to-fail” policy. It has long been clear that classifying the very large banks as “too-big-to-fail” creates perverse incentives for them, and serious competitive problems for other banks. Nevertheless, none of the federal regulatory agencies even considered merger restrictions to prevent banks becoming “too big to fail.” The lack of appropriate policy in this area can be explained by the fact that no one agency would be willing to restrict acquisitions by banks within its regulatory domain unless the others would follow suit: Coordination in this area could not be expected.

Another example involves exogenous shock and monetary surprise. A proper focus requires analyses that increase supervisory awareness of bank vulnerabilities. It has only been in recent years that serious efforts have been made to incorporate interest-rate risk and interest-rate change scenarios into supervisory calculations (Haupt & Embersit, 1991; see also Hanweck & Shull, 1993). Of the federal regulatory agencies, only the Federal Reserve appears to be clearly aware of the problem (Federal Reserve Board, 1984), but none have dealt with it effectively.<sup>7</sup>

A source of the difficulty is that "leaning against fragility" by one agency leaves it exposed to severe criticism when other supervisory agencies are not doing so. In the past, it has placed the Federal Reserve in the way of banks and other regulatory agencies that literally did not see the reasons for foot dragging.

Finally, as noted, the fragmented system has tended to erode constraints in general (i.e., promoted a competition in laxity). In this way, the system attacks its own effectiveness and legitimacy. Agency competition, if not agency differences, implies that supervision is arbitrary, and supervisors can be viewed as capricious in insisting on any particular set of rules. Hence, evading supervision and regulation takes on the character of an activity for which the social consequences are trivial.

The seeming arbitrary nature of supervision suggested by differences among the agencies is fertile ground for the growth of insider abuse and, more generally, opportunism. In turn, opportunism tends to compromise supervision. Supervisors become torn between their obligations to support bank profitability on the one hand, and to prevent dubious practices (which, *ex ante*, are not obviously abusive, and which seem to contribute to profitability) on the other. In periods of prosperity, they may be reluctant to substitute their judgement for that of bank management, and reluctant to restrict the banks they supervise when their competitors, supervised by others, are not restricted. In times of bank distress, difficulties arise for the same underlying reason. In addition, when supervisors are confronted with banks at or near insolvency, they become understandably anxious to find buyers who will inject new capital. The S&L experience of the 1980s suggests that standards for evaluating the character of new owners can suffer in the anxiety to find investors.

### III. INADEQUACY OF THE 1989-91 REFORMS

Recent banking legislation, particularly FIRREA and FDICIA, has aimed at remedying the problems that have emerged. While moving toward uniformity of specific regulations by legislative mandate, and also toward analyses of some types of bank vulnerability as opposed to existing weakness, neither of these acts meets the objectives of agency unification. Both reflect the traditional tendency to augment supervisory authority in response to banking problems.

FIRREA included major changes in supervision that affected not only savings associations but other depository institutions and bank holding companies. In general, it tightened constraints on federal savings associations, extended federal constraints to state-chartered associations, and imposed other restrictions applicable to national and member banks. Among other things, it raised the capital requirements of savings associations to levels no less stringent than those applicable to national banks (Title III, Sec. 301), and imposed National Bank and Federal Reserve Act limits on lending to one borrower, lending to insiders, and on interaffiliate transactions (Title III, Sec. 301). It prohibited institutions not meeting capital requirements ("troubled institutions") from engaging in certain activities, including accepting brokered deposits, offering above-market interest rates on deposits, lending to business development corporations, increasing assets, and, for state associations, exercising "expanded powers" permitted under state law. The FDIC was given "backup enforcement authority" over all savings associations.

Moreover, FIRREA augmented the authority of all the federal agencies to ferret out potential problems, impose timely restrictions, and discipline recalcitrant bank officials (Title IX). In addition to strengthening criminal sanctions, it substantially increased civil money penalties, up to \$1 million per day, for violating written agreements or orders, or for filing false or misleading reports.

Comprehensive reform was again proposed by the Treasury in 1991 (*Treasury Report*). An "administration bill," based on the *Report*, was introduced in Congress. The bill, which provided for the recapitalization of the Bank Insurance Fund (BIF), included measures to relax restrictions on interstate branching, lift restrictions on securities and insurance activities, and permit ownership of bank holding companies by commercial firms.

The act that was passed, FDICIA, did not adopt the administration's pro-



posals on branching, new activities, or holding company ownership. But it did augment supervision in a number of ways by: (1) requiring that federal supervisors perform additional on-site bank examinations through annual independent audits for larger institutions (Title I, Secs.111-12); (2) giving supervisors authority to prescribe and enforce detailed managerial and operational standards for purposes of "safety and soundness"; and (3) further extending federal authority to state banks by imposing limits on insurance underwriting and equity investments to those applicable to national banks (Title III, Sec. 303).

Of particular importance, FDICIA elaborated the "troubled institution" approach of FIRREA by establishing a system of "prompt corrective action," involving the imposition of escalating constraints on undercapitalized banks (Title I, Section 131). Five capitalization categories were established: "well-capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." The law requires federal banking agencies to augment conventional risk-based standards, based on book values, with requirements based on interest-rate risk.<sup>8</sup> A determination by the relevant federal supervisory agency that a bank is in one of the lower three categories automatically triggers the requirement that it submit an acceptable capital restoration plan. "Undercapitalized" banks failing to submit and implement an acceptable plan are subject to constraints on asset growth, nontraditional activities, transactions with affiliates, and deposit rates of interest, among others. Those "critically undercapitalized" are subject to additional constraints and, under the law, must be closed promptly.<sup>9</sup>

This approach may seem to compel federal agency uniformity for the three commercial bank regulators, and to limit supervisory discretion. But in key areas, the limit on discretion is illusory. The federal supervisors have been given broad authority to develop cooperatively the capital adequacy thresholds that activate supervisory constraints. It was recently noted that "...the regulators have opted for a narrow definition of 'undercapitalized' that sticks less than 5% of the industry with the unwanted label." Andrew Hove, Chairman of the FDIC, was reported to have acknowledged that "(w)e could have set the capital levels a lot higher" (Rehm, 1992). And the required closing of a "critically undercapitalized" bank is subject to agency-determined exceptions; it need not be closed if the bank's federal supervisor and the FDIC jointly determine that it has an acceptable capital restoration plan and is viable.

#### **IV. BASES FOR UNIFICATION OF THE REGULATORY AGENCIES**

Even after the major legislation of the past several years, there remain urgent reasons for unification of the federal banking agencies. These reasons emerge in a critical analysis of the Treasury's proposal for regulatory agency reorganization in 1991 (*Treasury Report*). The *Report* proposed that the FDIC be relieved of direct supervisory authority over insured state nonmember banks, that authority over national banks and thrifts (now in the OCC and the OTS) be consolidated into a new Federal Banking Agency (FBA) in the Treasury Department, and that federal authority over state-chartered banks be consolidated in the Federal Reserve. Holding company authority would be divided between the new FBA (if the lead bank were national) and the Federal Reserve (if the lead bank were state-chartered).

The apparent result would be a reduction in the number of federal supervisory agencies from 5 to 3 (FBA, Federal Reserve, and National Credit Union Administration [NCUA]). In fact, FDIC supervisory responsibilities would not be eliminated, and the proposal fails to recognize any need to unify the monetary authority with bank supervision.

##### **A. Supervision by the Deposit Insurance Agency**

It is not practical for the FDIC to withdraw from the exercise of its supervisory authority, or to abstain from involvement in the development of regulations that effect bank solvency (e.g., capital requirements). The Treasury proposal would not effectively "consolidate" by nominally eliminating the FDIC's authority over insured nonmember banks.

The moral hazard and excessive risk-taking because of deposit insurance has required the FDIC to have supervisory authority to protect its fund. In recent years, depletion of federal deposit insurance funds has resulted in legislation expanding FDIC authority. Under Title II of FIRREA, the FDIC's regulatory authority over both federal and state savings associations was expanded. Under FDICIA, the FDIC has been given similar authority over state-chartered commercial banks.

Any asserted "conflict" between insurance administration and bank regulation appears, at best, an undeveloped hypothesis that seems to have emerged from the observed behavior of the now defunct Federal Home Loan Bank Board (FHLBB) and Federal Savings and Loan Insurance Corporation (FSLIC) in the 1980s. The FHLBB kept insolvent S&Ls open, it is alleged, at the expense of prudent insurance administration (See, for

example, Clark, 1989, pp. 240ff.). However, no evidence is available to indicate that an independent FSLIC would have closed S&Ls earlier. Forbearance might just as easily be seen as a joint failure in competence and/or foresight.

### **B. The Role of the Federal Reserve**

From time to time, the Federal Reserve has argued that it must continue its involvement in supervision because monetary policy periodically imposes severe pressure on bank reserve positions, bank liquidity, the value of bank assets, and, indirectly, on the ability of bank borrowers to repay their loans. The standards established by other agencies are not likely to be adequate for monetary policy purposes.

“(T)he failure of supervisors...adequately to have foreseen potential strains...can either constrain the ability of the central bank...to meet monetary policy objectives or create a situation in which...monetary restraint pushes the stability of the system...beyond the breaking point.” And “...supervisory arrangements should encourage continuing concern with the ability of the banking system to withstand potential pressure even during long periods of fair weather, when temptations may develop to cater to the instincts of the most aggressive banking entrepreneurs” (Federal Reserve Board, 1984, pp. 549-50).

Further, it has been argued that evaluation and modification of standards can only be accomplished through an active supervisory role (Federal Reserve Board, pp. 551-52; Greenspan, 1991, p. 34). Finally, as a lender of last resort, it requires leverage to reduce the likelihood of crises (Federal Reserve Board, pp. 548-9).

Monetary restraint in the early 1980s provides an illustration of the problem visualized. As Brumbaugh has observed, “(i)n October 1979 the Federal Reserve made a decision with ruinous results for the thrift industry....(It) changed from a policy of stabilizing interest rates to...slowing money growth rates to combat inflation. This led to...an unprecedented increase in thrifts’ costs...with almost no corresponding increase in revenues....(1988, p. 15). Unable to withstand the strains of high and volatile interest rates, the result for S&Ls was a “financial holocaust” (Gray, 1984, p. 1598).

One can, in retrospect, censure the Federal Reserve for ignoring the problems of S&Ls and/or for its unwillingness to exercise restraint earlier (and presumably more gradually). In a fragmented regulatory system, however, Federal Reserve accountability has been obfuscated by the inadequate stan-

dards established by independent supervisory agencies whose policies were generally oblivious to the potential impact of monetary surprise and other exogenous shocks. The defect does not lie with individual agencies, but with their separation from one another.

The responsibilities imposed by monetary policy, as currently conducted, require an involvement in the supervision of all depository institutions. A continuous stream of current information on the condition of banks is needed to ascertain the likely effects of policy. While it is not possible to anticipate a particular shock, more can be done in preparation.<sup>10</sup>

It is noteworthy that the principal government studies of the last 30 years have reserved a role for the Federal Reserve, apparently concurring with the *Bush Report* that: "...the FRB should maintain...supervisory and regulatory authority to back up its responsibilities as the central bank" (p. 48). But this "backup" objective cannot be met in a fragmented system.

## V. AN APPROACH TO REGULATORY REORGANIZATION

It is conceivable that agency differences might be overcome by negotiation and agreement, informally or through formal interagency organization (Holland, 1975), but it is unlikely. There is little evidence that informal negotiation has been effective. There has yet to be a full evaluation of the Federal Financial Institution Examination Council (FFIEC), but without authority to impose even negotiated recommendations, this organization cannot be viewed as a reasonable substitute for consolidation.<sup>11</sup>

In considering regulatory reorganization, the objectives need to be kept in mind. In general, unification of the regulatory agencies is needed for purposes of efficiency, policy planning, and establishing accountability. In particular, it is needed to come to grips with the systemic problems that afflict the banking system. At the same time, there may be benefits associated with a multiple agency structure that should be retained, if possible; in particular, protection against the weaknesses of excessive concentration of regulatory power.

Alternative organizational structures can be considered. A new agency might be established into which the existing ones would be merged—or all could be merged into an existing agency. Substantively, there would be no real difference, but merger into an existing agency is likely to involve a simpler transition.

Of the existing agencies, consolidation might be in the Treasury (Office of the Comptroller of the Currency), the Federal Reserve, or the FDIC [the smaller NCUA does not seem a likely candidate]. The principal distinction would be between an executive branch agency and one that is "independent" (i.e., directly responsible to Congress). Consolidation in the Treasury would mean the elimination of an independent Federal Reserve. While this has been proposed from time to time, it raises issues that are likely to evoke more controversy than regulatory reorganization: What remains is consolidation in the Federal Reserve or the FDIC.

There are independent reasons for selecting consolidation in the Federal Reserve. It is the only banking agency whose structure was originally designed to deal with concerns about "concentration of power" (*House Banking Report*, 1913, pp. 11-12). Despite subsequent changes, it still retains quasi-independent regional banks and diversified public and private representation. It appears to be a rare, if not unique, governmental organization in that internal differences have been publicly disseminated over long periods of time.

While there are some practical reasons for taking this route, others may dictate a new organization entirely. If this were the case, each function, including monetary policy, could be established as a "subsidiary" of a new, loosely controlled, holding company-type agency. Resolution of differences, coordination, and general policy planning would be ultimately imposed by a "parent" board.

The functional subsidiary model would preserve the separate identities of each "function," and some intra-organization rivalry. With both regional (Reserve Bank-like organizations) and functional subsidiaries, there should be possibilities for both experimentation and innovation.

Because of the agglomeration of banking and monetary authority in one agency, some modification of the board might be considered, whether or not consolidation was within the existing Federal Reserve System. The "Executive Directors" of the functional subsidiaries might be appointed by the President with the consent of Congress, and also serve as Governors of the parent board. The interests of the executive branch might be accommodated by including the Secretary of the Treasury on the parent board. Because there is a need for accountability, the terms of office for the board members might be 5 or 6 years rather than 14 years.

Any such overhaul of the current regulatory organization requires, of

course, more detailed development. A full examination of structural options is in order.

One final point merits attention: The operational difficulties created by meeting the complex objectives of regulation and supervision suggest a need to raise the level of qualification for top supervisory officials. Within the context of the proposed organizational structure, supervision should command leadership of the first rank, no less qualified in economic and financial market analysis than Federal Reserve Board chairmen. The qualities that some high-level supervisors currently bring to the job have been insufficient to deal with the problems supervision must deal with if it is to be successful.

## **VI. CONCLUSIONS**

A regulatory reorganization to promote efficiency, planning, and accountability is needed. There exists a strong case for full consolidation of bank regulation and supervision, deposit insurance and monetary policy. In particular, the fragmentation of the regulatory system may be viewed as an institutional failure that needs to be overcome to address other systemic problems that have repeatedly resulted in banking problems.

An approach to regulatory agency consolidation that would combine the related functions in either a modified Federal Reserve System or a new organization modeled on a functional subsidiary basis is proposed. Such reorganization would integrate supervision and regulation with monetary policy and deposit insurance, and facilitate effective agency planning while sustaining the values of the existing arrangements.

*The author wishes to acknowledge the helpful discussion with and comments by Hyman Minsky of The Jerome Levy Economics Institute, and also the comments of Phillip Bartholomew of the Congressional Budget office, Joe Cleaver of the Federal Financial Institution Examination Council, and Gerald Hanweck of George Mason University on earlier versions of this paper.*

## Endnotes

- 1 More extensive development of the bases for the proposal may be found in Shull, 1992; see also Shull 1993.
- 2 The recent recovery is largely attributable to an unprecedented spread between long-term and short-term rates. It is indicative, as discussed below, of the effects of monetary policy and related macro-economic conditions on bank profitability.
- 3 Shocks have been defined as low probability hazards carrying high potential costs (Guttentag & Herring, 1986, pp. 2, 32-33). It has been observed that "the continuing potential for credit crunches has usually been underestimated...." (Kaufman, 1991). Bank management has no basis on which to calculate probabilities. Such events, it has been suggested, do not emerge from an ergotic process (Davidson, 1988, pp. 332-33, and 1991). In these circumstances, rational expectation and efficient market axioms do not apply.
- 4 In addition, supervisory efforts to strengthen weak banks focus on earnings from which most new bank capital has come. Restraining weak, much less seemingly healthy, banks in a vigorously growing economy, and in the face of unrestrained competitors, conflicts with traditional supervisory aims to support bank earnings and not to interfere with successful bank management.
- 5 The term "insider abuse" refers to "misconduct" by officers, directors, and other insiders of depository institutions for purposes of personal enrichment, without regard to the safety and soundness of the institution, and in violation of civil banking laws or regulations and/or criminal banking laws. "Criminal misconduct" ("fraud") refers to criminal acts committed by "insiders" for the same purpose (*Federal Response to Criminal Misconduct*, 1984, p. 2). The growth in insider abuse and misconduct is evidenced in congressional reports, orders by regulatory authorities, criminal referrals, civil suits, and the expansion of bank examination staffs and costs (*Fraud in America's Insured Depository Institutions*, 1991; *Effectiveness of Law Enforcement Against Financial Crime*, 1990, pp. 397-98, 444; Seidman, 1990; *Federal Response to Criminal Misconduct*, 1984).
- 6 Stewardship has been defined as involving a trust relationship in which the word of a party can be taken as its bond (Williamson, 1975, p. 26); it suggests some degree of self-denial, at least in the short run, and obedience to rules.
- 7 An adjusted risk asset approach was originally adopted by the Federal Reserve Bank of New York in 1952. In 1956 it added a liquidity test that required more capital from banks that were less liquid (Crosse, 1962, pp. 173ff.). The board amended its capital adequacy approach in 1972 to consider the experience of banks in the 1969-70 period of disintermediation (Vojta, 1973, p. 11; see Appendix 2 for the revised ABC form developed by board). The Fed's approach was differentiated from that of the Comptroller of the Currency, who deemphasized "ratio analysis" in favor of general guidelines "...appropriate for banks operating in normal conditions" (Vojta, 1973, p. 11).
- 8 A joint proposal by the Comptroller of the Currency, the Federal Reserve, and the FDIC was issued July 30, 1992, and revised March 31, 1993. See Hanweck & Shull, 1993.

- 9 Final rules, including the definitions developed by the federal supervisory agencies, but not including requirements for interest-rate risk, were issued in September 1992 and went into effect on December 19, 1992.
- 10 Accounting systems that reveal bank exposure to nonspecific events of varying impact would inform supervisors and give them some leverage in confronting bank managements (Minsky, 1971, pp. 124-29; Minsky, 1975; Guttentag & Herring, 1988). It should also be possible to develop more complex models, with regional as well as national banking sectors, and to simulate economic and financial shocks.
- 11 A GAO study in 1984 was critical of its performance (Comptroller General of the U.S., 1984). For a history of the FFIEC from an insider's point of view, see Lawrence, 1992.



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