Regulators’ Incentives

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Regulators’ Incentives
What Have They in Common?
Keep making same mistake
Uncle Sam

- Suffers recurring financial debacles
- Vows reform!
- Does what expert regulators recommend
- Suffers another debacle
- Vows reform!
Reform
Key Points

• Regulators:
  – Had *ample powers* to keep banks safe
  – Did *not* adequately use their powers
  – Faced perverse *incentives* to be *lax* in good times

• No political *constituency* for bank soundness regulation—until it’s too late

• To fix system, we need to deal with regulators’ *incentives*
Regulators had ample powers to keep banks safe
Examples

• Total access to information
• Scrutinize operations
• Deny applications
• Take enforcement action:
  – Issue cease & desist orders
  – Impose fines
  – End bankers’ careers

Gets your attention
Challenge

Identify any significant U.S. bank soundness problem that regulators lacked power to prevent, constrain, or correct.
Dance of the Powers

• Congress: How could this happen?

• Regulators: Who’d have expected a bubble? We need more powers!

• Congress: Have a dozen! And don’t let this happen again

• Regulators: You can count on us next time!
More of the Same
Regulators Should Have . . .

• Increased required capital levels

• Used risk-based capital standards to:
  – Limit banks’ investments in riskiest MBS
  – Curb other concentrations of credit risk

• Limited banks’ exposure to largest financial firms
  – So large firm’s failure would not tank other banks

• Required largest banks to hold additional capital
Required Capital Levels

• Set in 1988 during crisis
  – Regional recessions
  – Lots of troubled loans:
    • Oilpatch; farmland; developing countries

• Regulators never increased required levels
  – Despite 2 decades of prosperity & record profits
Excessive Inter-Firm Exposure

We are the last Dodos on the planet, so I've put all of our eggs safely into this basket...
Risk of Cascade

• Failure of large bank could bring down other banks to which failed bank owed money
  – One bank would topple another

• Risk creates pressure for too-big-to-fail treatment
Statutes Subverted

- Congress required Fed to make rules limiting banks’ exposure to each other (1991)
- Fed adopted mushy, ineffective rules
- Nor did OCC properly limit banks’ exposure to large nonbank financial firms (e.g., AIG)
- Regulators actually subverted prudent statutes
Regulatory Failure

• Needless, costly & huge
  – Including failure to use discretionary powers
  – Cf. regulatory failures during 1980s

• Granting more discretionary powers won’t suffice
Regulators’ Perverse Incentives
Perverse Incentives

• Arise from:
  – Special interest politics
  – Nature of banking

• Discourage strong, timely action to protect bank soundness, insurance fund & taxpayers
Special-Interest Politics

• Risky banking confers immediate benefits concentrated in risky banks’ owners, managers, counterparties & borrowers

• Costs of risky banking show up slowly & are widely spread
  – Taxpayers are unorganized & usually pay little attention

• Organized, motivated few exert more influence than unorganized many
Impaired Accountability

• Hard to be sure of banks’ condition from outside
  → Hard for citizens to know if regulators are doing a good job

• Result: leeway for laxity
  – Regulators can do what’s popular & expedient without (immediately) hurting own reputations

• During good times, laxity is more popular than stringency—until it’s too late
Regulators’ Reputations

Your reputation suffers less from problems that develop on your watch than from problems that become public on your watch.
Upshot

• 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 is more popular than stringent regulation—until it’s too late
• Risky banks & their allies exert more political influence than taxpayers—until it’s too late
Bank soundness regulation has no political constituency — until it’s too late.
Banks Are Opaque

• Many bank assets lack ready markets
  • E.g., commercial loans
    – Management can manipulate valuation

• Result:
  – Hard for outsiders to tell bank’s true financial condition
  – Hard for citizens to tell whether regulators are doing a good job
Incentives → TBTF

Regulators’ perverse incentives promote too-big-to-fail treatment:

• Inadequate prevention

• Patterns of political expediency
Inadequate Prevention

Laxity & complacency mean:

• Big banks more likely to fail
• Banking system more vulnerable to systemic shocks
• Neglect of systemic reforms
  – E.g., clearing & settlement systems; credit exposure limits
Expediency

• Bailouts confer immediate, readily identifiable benefits concentrated in big banks’ uninsured creditors

• Costs of bailouts:
  – More diffuse
    • Higher FDIC premiums; larger fiscal deficit
  – Longer term
    • Greater moral hazard & potential for future instability
Expediency

More broadly . . .

• If you have no backbone in good times, how will you acquire one during a crisis?
  – Invertebrate in peace $\rightarrow$ invertebrate in war
Regulatory Fragmentation

Heightens regulators’ perverse incentives:

• Promotes interagency competition → unsound laxity
• Undercuts accountability
• Slows decision-making
• Divides authority over integrated banking organizations
• Leaves agencies weaker & more vulnerable to special-interest pressure
Aberration of U.S. Banking

• No other country has competing bank regulators

• No other U.S. industry has competing federal regulators
Solutions
Recommendations

• Make new independent agency responsible for all federal bank soundness regulation
• Give agency clear, focused, realistic goals
• Frame important statutes in ways that reinforce regulators’ accountability
• Strengthen capital requirements
• Strengthen rules for dealing with capital deficiencies
Unified Regulator

• Would supervise all FDIC-insured banks & thrifts + their parent companies
  – Board would include Treasury, Fed & FDIC

• Result:
  – Maximize accountability
  – Curtail bureaucratic infighting
  – Facilitate timely action

• Could better supervise integrated organizations

• More independent from special-interest pressure
Realistic Goals?

• Regulating systemic risk?

• Controlling enormous potential for moral hazard by regulation?

• Overcoming incentives for bailouts?
Umbrella Regulation

Regulating umbrella
Umbrella Regulation

Regulation by umbrella

Big Brella is watching you
Conclusion