The Fed Must Continue to Supervise Banks

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As we examine ways to restructure government to provide better services at lower cost, supervision and regulation of banks is a prime candidate. The current supervisory patchwork, with its overlapping and redundant functions, is unnecessarily cumbersome and raises costs for banks and their customers. However, any reform measure also must recognize the essential role banks play in the economy and assure that consumers are protected from financial instability.

A banking institution can now be supervised by as many as four federal agencies. In addition to raising costs, this approach diffuses accountability for policy actions gone awry. Any plan to consolidate bank supervision and regulation should stipulate that only one federal agency supervise each institution.

One supervisor per banking organization could be achieved in a number of ways. A U.S. Department of the Treasury proposal, however, would eliminate Federal Reserve System involvement in bank regulation (setting the rules) and supervision (enforcing the rules). This proposal would undermine the Fed's ability to carry out its mission as the nation's central bank: ensuring financial stability and promoting economic growth.

What Does the Fed Do?

The Federal Reserve has three critical responsibilities: to ensure financial stability, to implement monetary policy, and to oversee a smoothly functioning payments system (delivering checks and transferring funds). These responsibilities are mutually reinforcing and are integrally linked to the banking system.

Monetary policy cannot be conducted in a vacuum. It requires intimate knowledge of the working of banks and financial markets.

Central banks know from the experience of financial crises that regulatory policy and monetary policy directly influence each other. For example, banking crises can undercut monetary policy by discouraging lending and destroying consumer confidence. Furthermore, they can disrupt the ability to make or receive payments by check or to transfer funds. Bank supervision must extend beyond the objective of maintaining the financial health of individual banks to consideration of systemic problems.

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In managing financial crises, central banks throughout the world intervene to prevent problems in a few banks from spilling over to other banks or to financial markets. A supervisor concerned primarily with oversight of individual institutions has neither the experience nor the mandate to consider the systemic problems, a role for which the central bank is uniquely qualified.

A Better Solution

The dual objectives of regulatory consolidation should be to ensure financial stability and to simplify the regulatory process. However, the first of these two objectives is by far the more important: a well-functioning financial system must be the primary goal.

The goal of a single supervisor for each institution can be achieved without undermining the ability of the Fed to manage crises, implement monetary policy, and supervise banks in a manner consistent with monetary policy. The Federal Reserve should supervise and regulate state-chartered banks while the proposed Banking Commission should supervise and regulate federally chartered banks. The largest bank holding companies, which pose the greatest risk to the broader financial system, would continue to be regulated by the Federal Reserve, while the subsidiary banks in the holding company, regardless of their charters, would be regulated by the regulator of the lead bank.

This plan would provide a more coherent regulatory framework without impairing the ability of the Federal Reserve System to conduct the fundamental functions expected of it. The knowledge, authority, and practical experience gained from regulating and supervising banks enables the Fed to contain panics and other crises when they occur. Even more important, the Fed's intimate knowledge of banks helps it prevent panics from happening at all.

What The Fed Presence Has Meant in New England

The Boston Fed is acutely aware of the strong links between bank supervision and our other central bank responsibilities. Early in 1991, we experienced a series of bank crises that threatened to spread throughout New England. Privately insured credit unions in Rhode Island failed, directly affecting one in three residents of Rhode Island. The safety of $3 billion held in privately insured depository institutions in Massachusetts was also called into question. At the same time, the region's bank with the most deposits, Bank of New England, was failing and five of the seven largest banks in New Hampshire were in the process of failing. These situations threatened a loss of confidence in other New England banks and thrift institutions, potentially resulting in still more serious problems throughout the New England economy.

The Boston Fed provided emergency cash shipments of $320 million to stem bank runs throughout New England; provided examiners to assist banks in preventing runs; warehoused over $2 billion in collateral for emergency loans; and set up alternative payments mechanisms so that affected citizens would have access to their Social Security checks. All of these measures were possible only because the Federal Reserve had a day-to-day, hands-on role in regulating banks and was an active participant in the payments system.

In addition, because of the Fed's economic responsibilities, the Boston Fed has been active in trying to ameliorate the effects of the New England credit crunch, a credit crunch exacerbated by a regulatory approach that focused only on individual banks rather than the banking system as a whole.

Concerns about credit availability problems, which were particularly acute in New England, have contributed to the monetary policy stance of the Federal Reserve and to changes in regulatory policy. These problems could easily have been ignored if the Federal Reserve had no authority to examine or regulate banks.

Crisis Management in New England

It is instructive to review in more detail just how critical the Fed's practical experience was to averting a banking catastrophe in New England in the early weeks of 1991. In late 1990, Boston Fed exam personnel alerted top Federal Reserve management that a number of privately insured institutions in Rhode Island were likely to experience serious solvency and liquidity problems by the end of the year. Federal Reserve bank exam staff, based on their knowledge of the local banking market, informed Federal Reserve officers involved in providing discount window loans, emergency cash shipments, and wire transfers of funds that they should initiate contingency plans immediately.

Bank exam staff began at once to evaluate the solvency of the institutions, as well as the likelihood of bank runs. Because discount window loans must be fully collateralized, Federal Reserve bank examiners were used to appraise collateral offered to qualify for discount window loans and to make sure that the Reserve Bank could perfect its interest in the collateral. The discount function has many similarities to the work of bank examiners, involving as it does the evaluation of loans, appraisals of collateral, and verification of the secured interest; the examiners' work was critical to our ability to respond quickly to the need for establishing sufficient collateral for discount window borrowing. Bank exam staff worked with the management of the involved institutions to explain how to qualify for discount window loans and were active, along with our operations staff, in the preparations for delivery of emergency cash shipments, should they be needed.

At the same time, contingency plans were prepared in case the problem became more widespread. As I have mentioned, in Massachusetts $3 billion in deposits were held in privately insured institutions that potentially could experience runs. Bank of New England already had experienced well-publicized problems (resulting in the warehousing of over $2 billion in collateral for emergency loans), and five of the seven largest depository institutions in New Hampshire were close to failing and susceptible to large withdrawals.

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Moreover, in the last week of December Capitol Bank and Trust of Boston, with over $400 million in assets, was liquidated, resulting in losses to depositors holding more than $100 thousand in deposits. These losses were widely publicized, particularly because they directly affected some Massachusetts cities and towns that held large deposits with the bank.

Closings of Privately Insured Institutions in Rhode Island

On New Year's Day 1991, all the privately insured Rhode Island institutions were closed by newly elected Governor Sundlund. This immediately raised a host of operational problems. Social Security checks that were directly deposited could not be delivered to closed institutions, and alternative systems had to be created so that Social Security beneficiaries could get access to their funds. ATM access to deposits in closed institutions had to be dealt with. Checks on closed institutions had to be returned. All of these activities had to be carried out on a holiday weekend. Because of the Boston Fed's "hands-on" experience with banking institutions and operations, gained from bank supervision and from active involvement in payments issues, we were able to resolve these payments problems quickly and with minimal disruptions. The severe hardship to depositors and taxpayers created by the insolvency of a private insurance fund (RISDIC) remained, however, and the effects will be felt for years.

The publicizing of the losses to uninsured depositors at Capitol Bank, as well as the plight of privately insured depositors in Rhode Island, significantly heightened the New England public's concern about the safety of their bank deposits. Over the following week, numerous federally insured institutions, primarily in Rhode Island and southern Massachusetts, experienced runs, and toward the end of that week a full-scale run began on Bank of New England.

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These bank runs resulted in 30 emergency cash shipments from the Federal Reserve Bank of Boston in the month of January, totaling $320 million. Bank examination staff were used extensively to help control the runs. They advised bank management on ways to minimize runs, assessed the health of institutions experiencing runs, and aided in collateral evaluation for discount window loans. They also monitored banks and bank branches for evidence that the situation was deteriorating. Because of the coordinated efforts of our operations and examination personnel, a more serious problem did not develop. Examination and supervision personnel were a critical component in containing the crisis and in preparing contingency plans that would have been used, had the runs become more widespread.

Unique Perspective of the Federal Reserve

A major difference between the Federal Reserve and other agencies is its sensitivity to systemic risk. Other agencies focus on the safety and soundness of individual institutions and the exposure of FDIC insurance to bank actions. The Federal Reserve, in addition to these considerations, must also be aware of how problems can spill over to other participants and markets. Thus potential systemic problems may best be avoided in ways other than increasing the money supply or providing discount window loans. For example, many of the foreign exchange contracts for Bank of New England had losses. Had the supervisors not allowed these contracts to be honored, which would have minimized the cost of one institution's failure, investors might then have been unwilling to enter foreign exchange contracts with any but the most healthy U.S. banks. In this case, minimizing the cost to the deposit insurance fund for one institution conflicted with the need to maintain access to foreign exchange contracts for all other U.S. banks.

Federal Reserve examiners also play an important role in preventing crisis situations. As new bank practices are developed, new risk exposures uncovered, and new regulations adopted, Federal Reserve supervisory staff are particularly sensitive to possible systemic risk. They are in a position to alter bank behavior that poses potential systemic problems, both through changes in regulations and through supervisory activity. They can also communicate their concerns about systemic problems directly to Fed operations personnel at the discount window and in wire transfer. Examiners focused solely on the safety and soundness of individual banks frequently do not have the training and the interaction with payments operations that are critical in identifying possible systemic problems.

Implementation of Monetary Policy

The New England experience also highlights the relationship between bank examination and supervision and the implementation of monetary policy. Despite a rapid expansion of bank reserves, the U.S. economy recovered quite slowly from the recent recession. Contributing factors have been the credit crunch and regulatory actions that have discouraged banks from lending. If capital requirements are binding, additional reserves will not result in more lending.

This problem has been particularly apparent in New England, and the Federal Reserve Bank of Boston has been vocal in its concern over the ways that bank regulation and bank behavior can reduce the effectiveness of stimulative monetary policy. The realization within the Federal Reserve System that bank regulation was creating a credit crunch contributed to the monetary policies followed since 1989. While monetary policy may not have fully offset the impact of the credit crunch, policy probably would have been less stimulative had the Fed not been aware, early on, that tighter lending policies by banks were a drag on the economy.

More generally, the common indicators of monetary policy—the monetary aggregates, the federal funds rate, and the growth of loans—are all influenced by bank behavior and bank regulation. Understanding changes and taking action in a timely fashion can be achieved only by maintaining contact with examiners who are directly monitoring banks.

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The banking system is a major transmission mechanism for monetary policy, and it is critical to have personnel in the central bank who have more than an "ivory tower" understanding of bank operations. This can only be obtained by direct contact with banks; it is not available in financial statements and examination reports. Eliminating the Federal Reserve's regulatory and supervisory function would deprive the central bank of complete information about the ways that levels of reserves, movements of monetary aggregates, and fluctuations in the federal funds rate are being affected by regulatory policy and decisions by bank management. Optimal monetary policy is unlikely when the means of understanding the instruments of monetary policy have been removed.

Not only must the Federal Reserve be informed about banks and bank regulation in order to implement monetary policy effectively, the Fed also needs the authority to change bank behavior that is inconsistent with its established monetary policy and with financial stability. This requires both the responsibility for writing the regulations and the responsibility for enforcing those regulations through bank supervision.

A Restatement of the Fed's Proposal

If we were to limit ourselves to a single bank regulator, the choice would be clear: it should be the central bank. One consequence of the Administration proposal would be to make bank regulatory policy more sensitive to concerns of the legislative and executive branches. This experiment has already been tried. The regulation of the savings and loan industry was highly sensitive to the political process, even though it had "independent" regulators. The savings and loan experience demonstrated that funneling credit through a politically sensitive regulatory process can result in short-run gains at far greater long-run costs to the economy. To expect these mistakes to be avoided this time would be excessively optimistic. The incentives would be unchanged, and well-financed lobbying groups overseen by politically responsive regulators remain a recipe for financial disaster.

Because regulatory policy affects monetary policy and systemic risk, at least some independence in decision-making is desirable. Nevertheless, a completely independent agency may be insufficiently sensitive to current policy concerns. The obvious compromise is to have two federal regulators, with non-overlapping jurisdictions. The Federal Reserve should regulate banks critical to its function as a central bank, which clearly include banks active internationally and banks active in a variety of financial markets and derivative instruments. These banks pose potential systemic risk to the payments mechanism and the economy. By and large, they are the largest bank holding companies, which account for the bulk of bank assets and liabilities and pose the most serious systemic risk. In addition, the Federal Reserve would regulate state-chartered banks. These would include many smaller institutions, enabling the Federal Reserve to keep in touch with financial institutions focused on small business lending.

A new Banking Commission would regulate federally chartered banks and thrifts currently overseen by the Comptroller of the Currency and the Office of Thrift Supervision. This organization would be more responsive to the political process but would decide jointly with the Federal Reserve on changes in regulations. This dynamic dialogue would ensure that considerations central to the Federal Reserve, as well as banking issues of concern to the Administration, were carefully considered.

While consolidation of the bank supervisory process is overdue, issues of bank supervision and regulation affect the entire economy. The ability of the Federal Reserve to contain and prevent financial crises and conduct monetary policy is far more important than overlapping administrative jurisdictions. Together a new Banking Commission and the Federal Reserve System could maintain the principle of one banking regulator per banking organization without sacrificing the ability of the central bank to conduct its major functions.