The Allocation of Regulatory Authority

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An area in which prospects for policy reform are not favorable and on which economics is less helpful in guiding policy is the reallocation of regulatory and supervisory authority. The increased weight given to Fed opinions about reform may not be helpful; the Fed’s main goal in such debates has always been to preserve and expand its own authority, which has not generally been in the public interest.

A lot is up for grabs in the reallocation of regulatory power, with one question being whether we should maintain the current system of multiple prudential bank regulators. The Office of the Comptroller of the Currency regulates national banks, the Fed regulates Fed-member, state-chartered banks, the FDIC regulates state-chartered, non-Fed member banks, the Office of Thrift Supervision regulates nationally chartered thrifts, and the Securities and Exchange Commission (SEC) regulates investment banks. Some critics fear that a “race to the bottom” could ensue as regulators compete to attract banks to their sphere of influence through lax standards. But the traditional view among banking historians has been that competition among regulators, who otherwise may be excessively prohibitive in their approach, fosters better regulation and supervision.

Although no convincing evidence supports the race to the bottom argument, not much more evidence exists to support benefits from regulatory competition.

A second question is whether banking regulation should be compartmentalized (e.g., separating prudential regulation from consumer protection regulation) to improve enforcement. Aspects of prudential regulation may conflict with regulation designed to foster access (e.g., encouraging banks to tolerate greater risk when lending to low-income borrowers). Some advocates favor creating separate bodies for consumer and prudential matters so that each supervisory/regulatory body will have a clear, focused agenda.
Others argue that combining consumer protection and prudential regulation in the same regulatory authority prevents regulators from issuing contradictory instructions.

Third, now that new regulatory actions relating to large, systemically important financial institutions are being proposed, where will those new authorities be housed? The Fed is perhaps the most likely choice. It possesses the resources and breadth of perspective to gauge risks and relevant trends in the economy better than any other macro prudential regulator. Furthermore, as the central bank and a lender to financial institutions, it already needs to maintain timely information about systemwide risk. The Fed is also a candidate for the new resolution authority (and is explicitly favored for that role by Barney Frank). Congress prefers to vest powers in the Fed because it exercises more control over the Fed than over other financial regulators. With respect to resolution powers and other new micro prudential authority, however, many strongly argue against expanding the Fed’s role.

Indeed, policy makers should require the Fed to give up its role as a micro regulator, rather than expand that role through new resolution authority. Former secretary Paulson advocated reforms to remove the Fed from day-to-day regulatory and supervisory authority but gave it a new mandate to pursue macro prudential supervision and regulation.

Removing the Fed from micro regulation and supervision would have substantial advantages. The United States is almost alone among developed economies in relying on its monetary authority as its primary day-to-day bank regulator and supervisor. The Fed not only sets and enforces prudential and consumer regulations but approves bank mergers and acquisitions and decides what constitutes permissible activities for banks.
Why have other countries distanced their monetary authorities from such things? First, monetary authorities—especially when subject to political oversight by Congress, as the Fed is—may be less reliable regulatory enforcers. Second, combining regulatory powers with monetary authority politicizes monetary authorities, thus threatening independent monetary policy. Unfortunately, given the dominant role of the Fed in the current debates over the reallocation of power, there is little chance of distancing the Fed from the day-to-day responsibilities of supervision and regulation, despite the benefits.