As happens too often in Washington, major unfinished business from the financial crisis relates to public administration: trying to implement effective supervision of banks, and especially big banks. Only with boots on the ground can financial regulators try to ensure that an institution accurately detects and addresses major vulnerabilities in the way it does business. Also, financial supervisors can provide feedback to bank management, asking good questions and requiring good answers. Edmund Clark, chief executive officer of TD Bank, a bank that successfully navigated the crisis, articulates the goal: there must be “productive working partnerships between the industry and its regulators, enabling both parties to agree in principle on what needs to be done, and on the least intrusive way in making it happen.”

We are far from this halcyon goal. Especially managers of big institutions seem to believe they have little to learn from bank supervision. This became clear in the report of the U.S. Senate Permanent Subcommittee on Investigations on JPMorgan Chase’s $6 billion loss from risky trades in its “London Whale” episode. The subcommittee reported harassment of Comptroller of the Currency (OCC) examiners and, even after London losses came to light, “that obtaining information from JPMorgan Chase was difficult, as the bank resisted and delayed responding to OCC information requests and sometimes even provided incorrect information.” The subcommittee concluded, “The whale trades provide a striking case history of how a major bank, with 65 bank examiners on site, can keep a multi-billion-dollar derivatives portfolio off the radar screen of its regulator for [six] years, at least until it begins to lose money” (U.S. Senate 2013, 223–25, 217).

This type of failure traces back to basic causes. There have been improvements since the financial crisis, but these have not been sufficient.

Lack of Interest in Administration
At the Federal Reserve, supervision seems to play a modest role, for example, compared to the role of economists in developing and administering stress tests to set capital levels. Supervisors are located in a building far from the elegant offices of the Federal Reserve Board. The position of Fed vice chairman for supervision, created by the Dodd-Frank Act, continues to go unfilled. By contrast, the OCC seems to have learned from the crisis and commissioned an international review of its supervisory practices that it seems to be taking to heart.1

Imbalance of Strength between Supervisors and Banks
It is difficult for a bank supervisor to tell a bank to curtail activities that seem profitable. The credibility of such feedback is also limited because of major gaps in compensation and consequent status between bank examiners and bank officials. As seen in the JPMorgan Chase review, it can be difficult for examiners even to obtain information they request. Finally, supervision can be intensive in terms of staffing and systems; financial institutions are powerful players in the political process and can and do call on political allies to try to limit what they consider to be regulatory and supervisory burdens.

Split Jurisdictions and Organizational Complexities
Although Dodd-Frank eliminated the hapless Office of Thrift Supervision, and thereby made the Fed the sole regulator of bank and thrift holding companies, serious jurisdictional divisions remain. The OCC, which regulates national banks, must remain careful not to encourage a bank to change its charter and migrate to a more congenial state regulator; the potential for regulator shopping by banks similarly affects the Fed and the Federal Deposit Insurance Corporation.2 Even within the Fed, the organizational fault line between the Federal Reserve Board (a federal agency) and the private Federal Reserve Banks (governed by the banks they supervise) can make it difficult for supervisory information to flow to the place at the Fed where it is needed.
Fear Leading to Excessive Caution

The complexity of financial products, firms’ organizational structures, and statutory language make supervisors’ jobs difficult, especially because senior bankers may possess greater knowledge and technical expertise than examiners. That, combined with the influence of regulated institutions and concern about regulator shopping, can make examiners excessively cautious in their assessments and recommendations.

Are any solutions in sight? Canada and, since the crisis, some European countries provide good models of supervision. U.S. supervisors can be measured against those standards, with special attention to staffing, systems, and processes. It is also important to recognize that effective bank supervision depends on the regulatory culture; especially larger financial institutions need to be persuaded that even if supervisors may lack the technical qualifications of their bank counterparts, an independent supervisory agency can help generate useful feedback in the form of questions and observations.

Ultimately, quality of supervision must be strengthened so that chief executive officers—and their powerful trade associations—develop enough trust in the motivation and capability of bank supervisors that they assent when supervisors seek to curtail seemingly profitable but imprudent activities. While this is a tall order, the financial crisis was expensive enough to provide convincing evidence that the effort is worthwhile.

Notes

References