

Chapter 14 – The Regulatory Division of Labor – Challenges in the Crisis

Who regulates and supervises the financial industry? How do the regulators interact with the central bank as *lender of last resort* (LOLR) – the supplier of bank reserves in a liquidity crisis (described in Chapter 14)? The answers differ significantly across countries and currency regions.

Some countries have multiple regulators with overlapping jurisdictions. Some have only one regulator, or a small number with little overlap. Some countries assign supervision to the central bank (the LOLR); others do not. Prior to the financial crisis of 2007-09, regulatory experts expected that simple, streamlined systems would be more effective. That judgment still prevails, but the crisis exposed faults in every system. It also strengthened the case for making the central bank the leading financial supervisor.

At one end of this regulatory spectrum, the United States has a large number of overlapping regulators. The list includes a variety of federal and state agencies that typically are responsible for specific types of business, such as banking, insurance, securities or commodities (see Table 14.1 for regulators of depositories). The Federal Reserve – the U.S. LOLR – supervises bank holding companies, which operate the largest banks, and state member banks, but most U.S. intermediaries lie outside the Fed's regulatory umbrella.

As Chapter 14 highlighted, competition among U.S. regulators can speed financial innovation. However, the complexity of the system is also costly, especially if the regulators do not act consistently. When intermediaries can shop for the most lenient regulator, supervision may become ineffective. If regulators must vie for clients (intermediaries to supervise), they may try to protect these clients, rather than the public. Such behavior is called *regulatory capture*.

At the opposite end of the spectrum in the regulatory division of labor is the United Kingdom (UK). UK financial oversight is unified under one roof: the Financial Services Authority (FSA). The FSA is responsible not only for banks, but for the supervision of all financial markets, exchanges and firms in the country. The FSA was formed in 2000, when Parliament gave it the former supervisory role of the Bank of England (BoE), the UK central bank. The BoE remains the UK's LOLR. The UK separation of financial supervision and monetary policy was seen as reducing the risk that the central bank would be too accommodative in order to help frail intermediaries.

Countries on the continent of Europe are closer to the single-regulator model of the UK than to the U.S. model of multiple, overlapping regulators. Nevertheless, they often have separate regulators for financial markets and for intermediaries. In some European countries, the national central banks serve as bank supervisors. In other countries, the central banks have a more limited role. Importantly, the European

Central Bank (ECB) has neither a regulatory nor a supervisory role. However, its members – the euro area’s national central banks – are the LOLR in their countries.

The financial crisis of 2007-09 posed important tests of these different regulatory arrangements. Which structure was more likely to detect and respond to systemic risks? How well did each arrangement fare in addressing the liquidity shortfall? Was liquidity delivered rapidly where it was most needed?

The experience of the financial crisis does not instill confidence in any existing regulatory approach. In the United States, for example, the crisis underscored the dangers that developed during years of regulator-shopping. Having persuaded Congress not to impose stronger supervision, the government-sponsored enterprises (GSEs) toppled by the crisis were supervised by the small Office of Housing Enterprise Oversight (OFHEO). Because it had become a chartered savings institution,¹ the world’s largest insurer, AIG, was overseen by the Office of Thrift Supervision (OTS). As a result, AIG’s large credit derivative position – the source of risks that nearly sank the firm and threatened systemic disruption – was evaluated by a regulator familiar with savings banks, rather than with the giant traders of global derivatives.²

Above all, the crisis tested the emergency response mechanism of each regulatory system. Effective crisis management requires that policymakers receive and respond quickly to information about intermediaries and financial activity. Policymakers must act urgently to limit contagion from a weak financial institution, a loss of market function, or a threat to funding liquidity. In some cases, actions that preserve financial stability today can lead to financial and economic volatility tomorrow, so policymakers may need to make painful tradeoffs.

Multiple regulators certainly complicated the U.S. response. In the three most prominent systemic threats – Bear Stearns, Lehman Brothers and AIG – the Federal Reserve had no prior supervisory role. In the Bear and AIG cases, the Fed used its emergency powers to lend directly to nonbanks about which it had only limited information. Would better knowledge about Lehman Brothers have prompted the Fed to address that case differently? We can only speculate.

Shouldn’t the streamlined system in the UK facilitate rapid information collection and effective policy response? Not in practice. If anything, the UK experience in the crisis highlighted the problems that arise when the central bank is not the financial supervisor. Ineffective coordination between the FSA, the BoE and the UK Treasury has been widely seen as a factor in the 2007 run on Northern Rock – the first run on

¹ Chapter 12 defines a savings institution as an intermediary that provides mortgage and lending services to, and receives deposits from, households and individuals.

² OTS also supervised other savings banks that became the largest failures in the crisis, including Washington Mutual, Countrywide and IndyMac. President Obama’s proposed regulatory reform would eliminate OTS.

a major UK bank in more than a century. Apparently, the FSA had not shared with the BoE in a timely way its awareness of Northern Rock's risks.³

The lack of immediate, direct access to supervisory information also would seem to be a handicap for the ECB. Prominent policymakers have emphasized the need to improve the information flow among euro-area financial regulators and the ECB. During the crisis, however, the ECB may have compensated for its information handicap by acting early to flood the euro-area system with liquidity. In August 2007, the ECB was the first central bank to increase the supply of reserves sharply in response to heightened liquidity demands. Later, the ECB engaged in large dollar swaps with the Federal Reserve, in order to provide euro-area banks with scarce dollar liquidity (see Chapter 10 module: Currency Risk and Rollover Risk).

³ See Stephen Cecchetti, "Why Central Banks Should Be Supervisors," VOX, November 30, 2007. <http://www.voxeu.org/index.php?q=node/755>