What Is a Bank? What Is a Government? Addressing Regulatory and Supervisory Shortcomings That Plague Banking

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The parts of the academic world that study banks and governments take as their starting point an analysis of the frictions that make banks and governments necessary, which is crucial to comprehending how banks and governments behave. Both are intermediaries, and in their roles as intermediaries, they are not neutral or passive implementers of efficiency analyses. They are institutional embodiments of political outcomes, which express the will of the winning coalitions that have won messy political battles to put those intermediaries in charge of decisions that will favor the interests of the winning coalitions.

Of course, as intermediaries, banks aren't just political outcomes; as skilled market participants, they help to overcome market frictions related to physical and information costs, and competition helps spur them to behave in a manner that achieves the objectives of their clients when they build payments platforms, originate loans, and create portfolios for themselves and others. But as government-chartered entities, banks' behavior also reflects the rules that governments create for them: which activities they are allowed to pursue, who they are permitted to serve, what unprofitable actions they are forced to undertake, how their losses and profits are allocated (e.g., whether they will enjoy the protection of government to prevent losses to their depositors or stockholders). The incentives of bankers are shaped by all of these rules, not just by the incentives of the market.

Academic work on bank contracting shows how market frictions can explain banks' peculiar contracting structures—for example, why banks issue demandable debt to fund themselves, and why they make loans using complex warranties, collateral, and covenants of various kinds, which make bank loans very different from other types of debt. Academic studies also show how government policies affect bank contracting structures and decisions: for example, increasing the generosity of deposit insurance has been shown to substantially increase banks' willingness to undertake inefficient

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risks, the resulting costs of which are paid for by the deposit insurer and by society.[1]

When academics study governments, in the literature on political economy, we similarly consider how government decisions regarding bank chartering and regulation reflect the struggle among competing coalitions, not efficiency per se, and how frictions related to information and physical costs shape outcomes, especially because those frictions limit the knowledge and actions of individual voters.

For example, federal deposit insurance was not created in the US in 1933 because the government or its citizenry thought it was a good idea from the standpoint of economic efficiency. It was opposed by the American Bankers Association, the Federal Reserve, the U.S. Treasury, Senator Carter Glass and President Franklin Roosevelt. It was created nevertheless because small unit banks in places like Alabama, and the government representatives that favored them (such as Henry Steagall), insisted on creating federal deposit insurance as the price for supporting other legislative actions that FDR and Carter Glass favored.

If you doubt that, consider what candidate Roosevelt wrote in a letter to the *New York Sun* during the election of 1932: federal deposit insurance, he said, "would lead to laxity in bank management and carelessness on the part of both banker and depositor. I believe that it would be an impossible drain on the Federal Treasury." How did Roosevelt know that? Because eight state-enacted deposit insurance schemes had just fallen apart and wrecked the banking systems of their respective states in the years just prior to the 1932 election.[2]

Because the literature on bank regulation and supervision today understands that real-world banks and governments behave in predictably sub-optimal ways, it is capable of explaining why banks are able, despite market competition, to undertake unproductive and excessively risky strategies, and why government policies – especially prudential regulations related to bank failure risk – do not prevent banking crises.

From that perspective, the 2023 banking crisis is no surprise. Rather, it is part of the political equilibrium that creates and regulates banks. Those of us that propose new prudential policies that would reduce the risks of bank crises understand that the main

[1] Government policies in a contemporary developed country democracy like the US are a solution to a set of collective action problems, and if the solution persists, we can call it an equilibrium. The solution reflects rules of the political game (electoral system, Constitution, administrative state rules) and the and information and transactions costs of all the players in the game (individual citizens, and interest groups). Regulation of banks is not mechanically determined. The government intermediary serves a coalition that controls regulation for its purposes, not for the collective good (if that even can be defined). Regulation is "flawed" on purpose. Regulation, of course, pretends that this is not true because it is not helpful to the coalition to be honest about what it is doing. For a fuller discussion of how to think about bank regulation within such a framework, see Calomiris and Haber (2014).

[2] For a study of that historical experience, see Calomiris and Jaremski (2019). For a study of similar effects internationally in the past fifty years, see Calomiris and Chen (2022).

obstacle to reducing systemic risk is not the inherent weakness of banks, but rather, the political resistance to reducing bank risk, which reflects the preferences of the political coalition that is effectively in charge of bank regulation.

Where the academic literature has been less developed, however, is modeling and empirically investigating bureaucratic behavior, including supervisory failures, which the 2023 banking crisis shows were at least as important as regulatory failures for producing the crisis. Little of the literature on political economy has focused on the behavior of the administrative state and the bureaucrats that run it, including the entities and people in charge of examining and supervising banks. There are some new academic models that try to understand the incentives of regulators and how they shape outcomes (e.g., Topel 2023), but this literature is still in its infancy. The lack of understanding is particularly acute, and costly, when it comes to bank supervision.

Bank supervision is distinct from bank regulation. Regulation is about enacting the rules banks face, such as minimum capital ratio requirements or liquidity requirements. Supervision is about enforcing those rules, and also about supplementing those rules with additional bank-specific, customized, ad hoc prudential interventions based on the information supervisors observe as part of their regular examinations.

Supervision is intended to complement regulation, both by credibly enforcing regulatory rules, and by strengthening prudential behavior through prompt interventions as necessary when problems arise. These are not just powers that supervisors possess incidentally; they are central to their mission.

And yet, as the 2023 crisis showed, and as even the managers of the supervisory agencies themselves admitted (see the summary in Gillison 2023, the admissions in Barr 2023, and the candid and thoughtful discussion in Bowman 2023), both regulation and supervision failed to address clearly visible risks of bank failure for many months prior to the crisis.

The regulatory failures had to do with flawed accounting rules for measuring prudential standards (e.g., allowing banks to pretend that their assets were worth more than everyone knew they were worth). The supervisory failures had to do with not responding to those shortcomings with prompt supervisory actions to remedy the regulatory shortcomings by requiring the timely recapitalization of risky banks. I emphasize that it is precisely the role of prudential supervision to complement regulation by intervening to ensure that banks raise capital when they become vulnerable as the result of flawed regulations.

The failure of bank supervision in 2023 has been the subject of much commentary, including an excellent review of the facts surrounding the crisis by Kupiec (2023) and a new Financial Economists Roundtable Statement (2024) that I helped to draft, which analyzes the 2023 crisis and considers appropriate policy responses to problems the crisis revealed.

The key problems with supervision are two: (1) First, supervisors have unlimited discretion in determining whether intervention is needed, combined with asymmetric incentives to act. By unlimited discretion I mean that it is entirely up to supervisors, based on their unobservable and unaccountable measures of bank health, to determine whether banks are sufficiently troubled to provoke supervisory action (supervisory action includes both the initiation of potential discipline through a notification of a problem, and the subsequent enforcement of the discipline by giving the bank a credible hard deadline for correcting the problem).

By asymmetric incentives to act I mean that supervisors (a) face substantial pressure not to act quickly (including potentially strong political pressures by legislators or members of the administration who may act on behalf of banks to question actions by supervisors) and (b) face little ex post adverse consequences for failing to act. That combination produces substantial delays that allow recognizable problems to fester.

(2) Second, the culture of supervision (and the skills, tools, and procedures supervisors are taught) stresses multiple box-checking exercises, not the creation of a bottom-line overall measure of bank weakness. The lack of a single criterion that summarizes whether supervisory intervention is needed enhances the possibility of discretionary inaction in two ways: (a) It means that supervisors may themselves not be aware that intervention is needed, and (b) it means that supervisors who wish to avoid action (given the combination of unlimited discretion and asymmetric incentives already discussed) can do so with impunity by pointing to the ambiguity inherent in a multi-dimensional box-checking approach ("yes, the bank had some problems, but it also had some strengths").

It is important to recognize that there is some urgency to fixing these current shortcomings, both in prudential regulation (the failure to measure bank condition correctly) and in supervision (the failure to incentivize timely recognition and correction of bank weakness by supervisors). Jiang et al. (2023a, 2023b) identify roughly 600 banks that are either economically insolvent or on the brink of insolvency, which supervisors apparently continue to ignore.

What should be done? As the FER has recognized in its forthcoming statement (FER 2024), improving the measurement of bank condition is a crucial part of the solution to both the regulatory and supervisory failures. More accurately measured bank capital ratios will make supervisory interventions less necessary by automatically pressuring banks to maintain adequate capital.

A regulatory requirement that forces banks to raise more capital when their market value equity-to-assets ratio declines is helpful because this is the time when bank CEOs often resist raising capital because they believe doing so is dilutive (and therefore harmful to existing shareholders, including themselves).

Issuing shares into a declining market does tend to result in further reductions of price per share, which is often understood as reflecting the signaling effect of announcing an equity offering. As the 2008 crisis made clear, banks stood by and watched their market value equity-to-asset ratios decline markedly without doing what was needed to maintain them at a sufficiently high ratio. A regulatory requirement that forces banks to issue stock in the face of stock declines would overcome that resistance.

The creation of an accurate bottom-line supervisory measure of bank weakness (e.g., the "distance-to-default" measure commonly used in banking research to measure banks' risk of failure) would strengthen both the ability and the incentive of supervisors to act promptly. A single measure that captures overall risk is crucial to being able to have an actionable rationale. Otherwise, two-handed supervisors will always be able to say: "on the one hand, there are some positives, but on the other hand, there are some negatives." But such opinions are not useful for making decisions, or for holding decision makers accountable for the decisions they make. There is a reason that bond rating agencies boil their opinions down into a rating. Bond ratings weigh all the positives and negatives and incorporate all relevant information into a well-understood historical default risk category, such as BBB.[3]

That would be especially true if the overall measure of distance to default were combined with a specific timeline in which supervisory actions in response to measured weakness would be expected, which would require supervisors to explain any delays in action and therefore be more accountable for delays.

If those supervisory reforms were enacted, supervisors would face strong career incentives to act, would possess measures that provide a clear basis to justify their interventions, and would be able to counteract political pressures by pointing to objective measures of weakness and their own personal consequences for not acting. The "distance-to-default" measure would work best if it were also made public (even with a long lag) to ensure external supervisory accountability.[4]

Both of these sets of reforms, to regulation and supervision, respectively, are straightforward to accomplish, as the FER's recommendations make clear. First, with respect to capital standards reform, the FER Statement notes two alternative approaches to improving the regulation of capital ratios:

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[3] It is worth noting that supervisory agencies already construct composite ratings for banks (so-called CAMELS ratings), which are not disclosed to the public. Those ratings are not constructed in a way that quantifies an overall distance to default, but they would provide some of the potentially useful inputs to doing so. As research has shown (e.g., Gaul and Jones 2021), CAMELS ratings capture input fundamental information about banks that is related to default risk.

[4] During my time as Chief Economist at the OCC, the economics staff developed three approaches to constructing such measures based on observed equity prices and the Black-Scholes-Merton model, based on regressions that predict default, and based on simulations of cash flows. I am confident that there is no practical impediment to doing so.

…alongside the existing accounting measures based on balance sheet book values (including stress tests), we believe it is desirable to construct new regulatory measures that are more comprehensive in their approach to bank asset value and risk, and less susceptible to manipulation.

We highlight two alternative approaches to improving regulatory standards….

One approach to improving regulatory standards is to use the market value of equity to construct a prudential equity ratio requirement using market prices of equity if they are available. The market value of equity inherently incorporates market perceptions of the value of intangibles. One could, as some studies have recommended, compute on an ongoing continuous basis the moving average (say, looking back over the previous 90 days) of the ratio of the market value of equity relative to the sum of the market value of equity plus the face value of debt. By doing so, it becomes apparent that some banks over recent years, such as JPMorgan Chase, maintain a market equity ratio that is consistently substantially above their tangible book value ratio. Others, such as Citigroup, have maintained a market equity ratio much lower than their tangible book ratio. During the year preceding the 2008 crisis, as well as in the months preceding the 2023 crisis, declining equity values of banks could have offered very useful information about lost equity capital. In the present period, equity values of small and medium-sized U.S. banks continue to remain low and have not recovered from the March 2023 crisis, indicating that potential problems in many banks persist (a view that is corroborated by Jiang et al. 2023a, 2023b).

A market value-based minimum capital ratio requirement would require publicly traded banks with low economic capital ratios to raise new capital in a timely fashion. Economic resiliency should also be considered when evaluating the outcomes of stress tests. Currently, a stress test is considered a success if that bank's tangible equity ratio is sufficiently high after experiencing the stress. But that outcome could result in a potentially false conclusion if the bank's economic capital is low. This could have a detrimental effect on the ability of the regulator to monitor not only the health of the individual bank but its potential effect on systemic risk.

Another approach is to make use of market information in a more indirect way, using it to create incentives for bank managers to pay attention to market equity ratios when deciding to raise equity in the market to bolster their bank's safety. Flannery (2009) and Calomiris and Herring (2013) advocate requiring banks to issue a large amount of contingent capital (so-called CoCos that convert from debt to equity on a dilutive basis, if the market equity ratio is sufficiently low for a sufficient period of time).

Second, with respect to supervisory reform, the FER suggests requiring…

…supervisors to pay attention to signals they sometimes would rather ignore and get them to see discretionary delays in action as personally costly to them.

With respect to the supervisory dashboard, in addition to tracking bank condition based on the checklists associated with traditional bank examination, it is crucial to pay attention to measures that markets use to gauge banks' asset values and risks such as economic capital and distance to default as noted above. One cannot manage what one does not measure, and supervisory agencies have not designed their dashboards to measure the fundamental economic condition of banks on an ongoing basis. These, not just book values and check-the-box criteria, should be at the forefront of the supervisory dashboard.

….Imposing strict limits on how quickly banks must resolve problems that arise from the measures being tracked on the supervisory dashboard is essential.

For example, supervisors clearly possess detailed knowledge about the value and risk of bank securities. Changes in interest rates and in interest rate risk have clear implications for a bank's distance to default. As the distance gets smaller, the supervisor

should be forced to recognize the problem immediately and require the bank to resolve the problem quickly (within a pre-specified period of time).

Despite the obvious appeal of reforming prudential regulation and supervision to make them more meaningful and credible, and despite the broad consensus among economists specializing in this area that such reforms are desirable, there is not much chance of enacting such reforms, at least for the moment.

Under the current political equilibrium, which defines what is possible in bank regulation and supervision, the parties charged with regulatory and supervisory authority have not failed to implement such reforms because those reforms have never been suggested before, but rather, because these reforms actually would likely increase bank health.

As Calomiris and Haber (2014) explain, it's not that the political coalition in charge of banking policy wants banks to be unstable, per se; rather, it is that allowing banks to be unstable is stapled to other policies as part of a broader political deal that has been (and is likely to remain) a persistent equilibrium. That political deal benefits many parties, not just banks, and has key support in both of the major political parties.

Will the next banking crisis—perhaps looming on the horizon now—provide an opportunity for implementing meaningful reform? Crises, after all, can shake coalitions and change political equilibria. It is possible, but it is also worth remembering that the core problems in bank regulation and supervision noted here have not been addressed despite the illuminating realities of the banking crises of the 1980s, 2008, and 2023.

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