The Why of Bank Regulation

The growing complexity of financial services creates the potential for an unintended expansion of the federal safety net. Such an expansion, by weakening market discipline, would reduce the efficiency of our financial system.

In recent issues, *Region Focus* has begun to showcase various functions of the Federal Reserve Bank of Richmond and the Federal Reserve System. This issue features an article on the area of the Bank responsible for the supervision and regulation of commercial banks. Our story describes the wide array of activities of this department, from consumer protection to evaluating bank merger applications. The central mission of bank supervision and regulation in the Federal Reserve System, however, is to ensure the safety and soundness of the banking system. The Fed shares this mission with other federal and state bank regulatory agencies.

There have been a number of changes in recent years in the laws governing the activities of banks, and many of these changes could be characterized as deregulation. But the basic relationship between banks and the regulatory agencies has not changed. Through the bank examination process, the regulatory agencies monitor the riskiness of banks' loans, investments, and other activities.

Why do banks receive this special treatment? In most other businesses, shareholders and private creditors assess risks. Such assessments affect investors' willingness to hold a company's equity or debt securities. A company that mismanages its exposure to risk will be penalized by financial markets, as its cost of capital rises with investors' perceptions of risks. In other words, the financial market itself is the main source of discipline on the risk-taking behavior of most private businesses. In spite of some of the corporate scandals of the last year, this system of market discipline generally does a good job of aligning business managers' incentives with desirable company performance.

The key distinguishing characteristic of banks and other depository institutions is that they are covered by the federal financial safety net. For a company not protected by the safety net, if private investors fail to adequately monitor the company, the costs of that failure will be born primarily by those investors themselves. In the case of an insured depository institution, however, such costs may be shared with taxpayers through the deposit insurance funds. Since private investors are shielded from full exposure to losses, their incentive to monitor a bank's actions is muted. This is the basic rationale for the substitution, at least in part, of regulatory discipline for market discipline.

The regulation of banks for safety and soundness is universal around the world, because governmental safety net protection of banks is universal. Even in countries that lack explicit deposit insurance, historical experience suggests the likelihood that at least some banks would enjoy governmental support should they become insolvent. Bank regulation is a natural, and perhaps even essential, complement to a banking safety net.

The business of banking has undergone dramatic changes in recent decades. Technological advances, financial innovation, and the removal of long-standing legislative restrictions on the activities of banking organizations have all combined to blur the distinctions between commercial banking and other businesses in the financial services sector. The result has been the emergence of a new breed of large financial conglomerates engaged in a complex array of activities. While the activities of many smaller banking institutions remain closer to what one would traditionally think of as banking, these institutions have also been strongly affected by financial innovation. This process of evolution seems likely to continue in the foreseeable future. The key point here is that the growing complexity of financial services creates the potential for an unintended expansion of the federal safety net. Such an expansion, by weakening market discipline, would reduce the efficiency of our financial system. One of the challenges facing the business of bank supervision and regulation is to keep up with the changes in the business of banking so as to better safeguard the safety net. Aaron Steelman's article in this edition of *Region Focus* highlights some of the steps we are taking at the Richmond Fed to meet these challenges.

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