Discussion of
To Establish a More Effective Supervision of Banking: How the Birth of the Fed Altered Banking Supervision

by Eugene N. White

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A Return to Jekyll Island
November 5, 2010

Introduction

- Paper is well worth reading because

  1. wealth of historical information
  2. what it says about the importance of supervisory incentives and ability to take disciplinary actions

Introduction

- Paper describes and evaluates changes in banking supervision (and regulation) that occurred with establishment of Fed

- Paper's theses:
  1. Establishment of the Fed did not improve supervision and regulation of banks compared to National Banking System (NBS) at least in short run

  2. NBS's problems could not have been cured by better supervision & regulation
     caused by basic structure of NBS

Paper's Outline

- Supervision & regulation under NBS
- Changes when Fed established
- Why changes did not necessarily improve outcomes in terms of safety and soundness at least in short run

National Banking System

- Basic structure of supervision & regulation:
  - Required 5 call reports per year, 3 random
  - Two bank examinations per year
  - Disciplinary action: revocation of charter
- Outcomes:
  - Relatively low rate of bank insolvencies
  - Small losses to depositors and creditors

National Banking System

- White argues NBS has a bad rap due to numerous crises
- Crises due to deficiencies in NBS system,
  - lack of ability to branch
  - pyramiding of reserves
  - inelastic currency
  - lack of central bank
- Not deficiencies of supervision & regulation

Changes with establishment of Fed

- White discusses two changes that he argues were not for the good (at least as implemented)

1. Fed added as a regulator of state member banks
    - Led to more "competition in [supervisory] laxity" between potential regulators (OCC, Fed and states)
    - Fed wanted more state banks to be members
2. Establishment of discount window
    - Created moral hazard problems
    - Supervisors (regulators) allowed banks to borrow for too long

Comments

- "Supervisory Laxity"
  - Could present a stronger argument
    - In paper, decrease in the number of required call reports
    - Suggest compare insolvencies and losses of similar state member and nonmember banks
- Discount window
  - Presents a strong argument for moral hazard problem
    - 593 out of $\approx$ 9,500 borrowing for more than a year
    - 239 borrowing continuously from 1920 to 1925
    - 80% of failures over same period were "habitual borrowers"
  - Would have liked more documentary evidence ("What were they thinking?")
  - Evidence on differences across Districts

Thoughts

- Paper is about incentives, moral hazard, supervision, and disciplinary action
- Led me to this question:

  How can we get more "skin in the supervision/discipline game"?
- History suggests considering schemes with mutualization of losses

  where potential loss-sharers have supervisory and regulatory powers

Example 1: Suffolk Banking System

- Clearing system for notes of New England banks run by Suffolk Bank in Boston (1825-1858)
- Done through accounts much like those banks hold with Fed
- Mutualization of losses:
  - Suffolk held notes of other banks and had discount window type loans out to them
  - Would lose on these if a bank clearing with it failed
  - Total exposure greater than capital

Example 1: Suffolk Banking System

- Supervision:
  - Suffolk kept track of quality of other banks' balance sheets
  - Told banks to improve loan quality or risk being kicked out of System
- Outcomes:
  - New England banks had low failure rates
  - Financial stability: Occasions when NE banks did not suspend but banks in other parts of country did

Example 2: State Bank of Indiana (1834-1855)

- Despite name, system of independent, privately-owned banks called Branches

- Mutualization of losses:
  - Branches mutually guaranteed "all debts, notes, and engagements of each other"
  - Each Branch had $\approx 20\%$ of capital exposed if another Branch failed

Example 2: State Bank of Indiana

- Supervision:
  - State Board overseeing the Branches composed of
    - Some members appointed by legislature
    - 1 member from each Branch
  - Board had power to
    - Limit ratio of loans and discounts to capital
    - Limit dividends
    - Close a Branch
- Outcome:
  - No Branch ever failed

Conclusion

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  2. what it says about the importance of supervisory incentives and ability to take disciplinary actions