Twenty-first century supervision

Much of the regulation governing banks was developed in the last century. But it is time to stop trying to supervise twenty-first century financial institutions with twentieth century oversight tools, argues ***David Rowe***

Some historians refer to the 'short' twentieth century. Their argument is that the real cultural and political break with the nineteenth century did not occur until August 1914 and the outbreak of the First World War. Similarly, it is argued this era effectively ended in 1989 with the fall of the Berlin Wall and the collapse of communism in eastern Europe. It seems to me the idea of the short twentieth century also has relevance for current deliberations concerning regulatory reform and the future of financial supervision.

Most of the current structure of financial regulation dates back to the short twentieth century. In the US, the 1933 Glass-Steagall Act was a major turning point. By forcing a strict separation of investment and commercial banking, Glass-Steagall restricted commercial banks from trading in equity shares – where most of the real action in capital markets took place before the 1980s. As the end of the short twentieth century approached, however, the restrictions of Glass-Steagall gradually eroded.

This erosion coincided with the rise of the high-yield bond market, which offered once-captive bank customers an alternative source of financing. As an important part of their core business was threatened, banks began to exploit a provision of Section 20 of the Glass-Steagall Act, which prohibited bank affiliates from being 'principally engaged' in the securities business.

Regulators became concerned about eroding profitability of banks and were anxious to introduce greater competition in the provision of financial services. Increasingly, the 'not principally engaged' provision of Section 20 was used to allow banks to expand their capital market activities beyond the traditionally allowed areas of trading government bonds, municipal bonds, certificates of deposit and bankers' acceptances. Through a combination of sympathetic regulatory rulings and successful defence against a number of court challenges, banks steadily expanded their allowed activities throughout the 1980s. In 1988, the US Senate passed a bill to abolish Glass-Steagall but it failed in the House of Representatives. Nevertheless, the trend was clear as the short twentieth century drew to a close. Banks had effectively circumvented most of the restrictions of Glass-Steagall before it was officially repealed in 1999.

What is notably missing in this evolution of commercial banking is any corresponding change in the structural characteristics of financial supervision. The basic processes of regulatory oversight are still much as they were in the immediate post-depression era. Cornerstones of this process are regular reporting of aggregate data, supplemented by periodic onsite examinations of detailed books and records.

In conducting these examinations, US supervisors have unrestricted access to whatever information is deemed critical to meet their mandate for maintaining safety and soundness of the banking system. This includes personnel files, limit violations and their disposition, trade details, system performance metrics, and much more. The critical constraint is this information can only be viewed piecemeal and in the context of an examination. The process is effectively designed for supervisory oversight of a comparatively slow-moving banking system, such as that which preceded the erosion and ultimate repeal of Glass-Steagall.

Today, major banks play a huge role as market-makers for securities and also derivatives contracts of all varieties. This has dramatically accelerated the rate at which credit exposure across institutions can change and the complexity of the forces driving such changes. Clearly, periodic call reports with summary data and supervisory examination of detailed but fragmentary internal records can never hope to keep abreast of these changes. This approach provides even less of a foundation for evaluating the potential for such changes in advance, based on structural simulations of the impact of hypothetical market shocks.

If we want to achieve a significant improvement in financial regulation, there simply is no alternative but to mandate that highly interlinked financial institutions submit same-day details of all their transactions to a highly secure non-public database accessible to regulators. Combined with appropriate computing power to perform relevant simulation analysis, this could reduce the likelihood and mitigate the severity of future systemic crises. Perhaps of equal importance, it would force financial institutions to a level of internal transparency they have manifestly failed to achieve on their own. Continuing to regulate twenty-first century finance with twentieth century methods should not be an option. ■

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