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Umbrella Supervision

by Joseph G. Haubrich and James B. Thomson

Deregulation and financial consolidation have led to the development of financial holding companies—allowing commercial banking, insurance, investment banking, and other financial activities to be conducted under the same corporate umbrella—and the Federal Reserve has been named supervisor of the consolidated enterprise. This *Commentary* explains the increasing importance of an umbrella supervisor amid the sea of regulatory agencies, and why the Fed may be the best natural choice, both practically and conceptually, to assume the role.

Seven Blind Mice, a children's book based on an old Indian parable, tells the story of blind mice who visit an elephant. The first six explore the part of the elephant they happen upon first and each declares that he has discovered either a pillar, a snake, a cliff, a spear, a fan, or a rope. Only the seventh mouse, who explores the whole of the animal, deduces that it is an elephant. The lesson of this parable for policymakers and financial regulators is that only by assessing the activities of a company as a whole can its true risk be acknowledged.

In 1933, the Glass-Steagall Act was passed, shaping the evolution of the United States' financial system through a legislative blueprint that compartmentalized commercial banking, investment banking, and insurance. Not surprisingly, separate agencies were created to supervise these different areas, resulting in a patchwork quilt of functional regulators at both the federal and state governmental levels.

In the past several years, however, the lines between commercial banking and other financial services have become increasingly blurred. Deregulation, most recently in the form of the Gramm-Leach-Bliley Act of 1999 (GLBA), and earlier in the form of the Reigle-Neal Act of 1994, has lifted interstate branching restrictions and dismantled many of the statutory limits on financial consolidation that were the heart of Glass-Steagall. This legal sea change, along with technological innovations and financial engineering, make increased integration of financial markets and more competition among financial firms seem likely. However, consolidation does not seem as imminent for the regulatory agencies that will supervise these new and diverse financial services firms. Instead, GLBA has created a new type of bank holding company—the financial holding company, where activities such as merchant banking and insurance underwriting, which previously were not permissible for banking firms, are now allowed—and named the Federal Reserve, the seventh mouse if you will, as umbrella supervisor. (Thrift holding companies remain regulated by the Office of Thrift Supervision and investment bank holding companies by the Securities and Exchange Commission.)

■ Financial Holding Companies

There are several ways of conducting different financial services in the same organization: the universal bank as currently practiced in Germany, where all financial services are done within the bank; the bank subsidiary model, where nonbanking activities are done in separately chartered subsidiaries of the bank; and the bank holding company model, where nonbanking activities are done in firms owned by a parent company that also owns the bank. The United States has used the bank holding company form since the mid-1950s.

Prior to GLBA, bank holding companies could own banks, thrifts, and other firms engaged in activities deemed closely related to banking by the Federal Reserve Board. However, supervision of banks and thrifts owned by a parent holding company fell to the company's primary federal or state regulatory agency—its functional regulator—and supervision of nonbank subsidiaries of bank holding companies and the consolidated holding company fell to the Federal Reserve. Under this regulatory model, the "umbrella supervisor" of the holding company—the Fed—would examine a bank or thrift subsidiary of the holding company only under exigent circumstances, relying on the supervisory judgment of the primary supervisor to the greatest extent possible.

After GLBA was passed and the financial holding company was created, the framework was set for the consolidation of the financial services industry. However, GLBA did little in the way of regulatory consolidation. Even consolidating the Office of Thrift Supervision into the Office of the Comptroller of the Currency was not actively under consideration, despite both agencies being housed within the U.S. Treasury Department. Congress instead chose to adopt a functional-regulator approach for the new activities now allowed under GLBA. For instance, the Securities and Exchange Commission would regulate investment banking subsidiaries of a

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financial holding company, and the appropriate state agency (insurance commissioner or regulatory body in the state where the subsidiary is incorporated) would regulate insurance subsidiaries. Using these specialized industry regulators echoed the approach used to supervise banks and thrifts in traditional bank holding companies. It may not be a surprise, therefore, that the Federal Reserve was chosen to be the "umbrella supervisor" for the consolidated financial holding company, because Congress viewed this role as an extension of the Federal Reserve's role as the regulator of bank holding companies. In fact, this sentiment is explicitly stated in the Conference Report on the Gramm-Leach Bliley Act released November 1, 1999:

> Reflected in the legislation is the determination made by both Houses to preserve the role of the Board of Governors of the Federal Reserve System… as the umbrella supervisor for holding companies, but to incorporate a system of functional regulation designed to utilize the strengths of the various Federal and State financial supervisors.[1]

Moreover, to minimize the regulatory burden associated with this layered approach to the supervision of financial holding companies, the GLBA limits the Federal Reserve's ability to de facto regulate functionally regulated subsidiaries of financial holding companies.

■ Role of the Umbrella Supervisor

The parable of the blind mice illuminates how a functional regulator's assessment of a subsidiary may not reflect the true risk in the context of the entire company. The role of the umbrella supervisor is to piece together a consolidated picture of the financial holding company's risks—including management's ability to understand and manage those risks. In other words, the umbrella supervisor is charged with producing a comprehensive picture of an institution as the collection of its parts, leaving the regulation and examination of each holding-company subsidiary to its functional regulator. It is not just the parts but how they fit together that gives us the true profile of a financial holding company.

To further stress the importance of producing a comprehensive picture, consider the Butcher banks. The two Butcher brothers, Jake and C.H., Jr., owned or controlled approximately 40 depository institutions between them. Through what was known as chain banking, the Butchers' holdings included depository institutions in two of the Federal Deposit Insurance Corporation's (FDIC) jurisdictions and three Federal Reserve Districts. Unlike a bank holding company, this chain of commonly held institutions was not supervised on a consolidated basis. Depending on location, charter, and Federal Reserve membership status, examination of each separate chain-banking unit fell to one of the seven bank or thrift regulatory agencies involved, making it difficult for any single examination agency to detect systemwide problems. The lack of a comprehensive examination of their entire empire allowed the Butcher banks to hide asset-quality problems by shifting problem loans from one bank to another. Only after the FDIC conducted simultaneous examinations of all the major Butcher-affiliated banks were the problems detected, leading to the closing of eight Butcher-affiliated banks in 1983, with losses to the FDIC of nearly $383 million.

In addition to the need for comprehensive examinations, umbrella supervision is also necessary because the legal separateness afforded by the holding company structure is less and less an economic reality. Senior management and boards of directors are increasingly adopting enterprisewide risk management—aggregating risk at the corporate level in order to effectively establish risk limits and controls. New regulations, such as the Basel II capital requirements and Federal Reserve Board letter SR99-18, have further nudged banks and their parent holding companies toward organizing their risk-management and economic capital allocation plans according to lines of business, not legal entities. Hence, the need for aggregated risk information, coupled with economies of scale in information storage, retrieval, and processing, have reinforced the trend toward enterprise-wide risk management by diversified financial firms, including financial holding companies. Functional regulators provide an important level of review of risk-management systems at the legal entity level, but they cannot, by design, adequately assess the enterprise-wide, risk-management efforts, particularly when this function is housed in the parent company. This can only be done effectively by a supervisor with the authority to look at the consolidated organization.

Finally, choosing the financial holding company form as the model for consolidation stems from a desire to insulate bank and thrift subsidiaries from risks posed by the new activities. By extension, Congress sought to limit the federal financial safety net to the insured depository institution subsidiaries and thereby protect the federal deposit insurance funds (and by implication, taxpayers) from the same risks. In GLBA, Congress charged the umbrella supervisor with protecting the insured bank and thrift subsidiaries of financial holding companies, as well as the domestic and international payments systems, from risks associated with the functionally regulated nonbank subsidiaries of holding companies. Therefore, while the Federal Reserve is to rely mostly on the functional regulator for information on the condition of a subsidiary of a nonbank financial holding company, as umbrella supervisor the Fed has broad authority to examine any holding company subsidiary that is seen as a possible material risk to the health of the insured banking (or thrift) subsidiaries or to the payments system.

■ Umbrella Supervision and the Fed

As with any supervisor of financial services firms, the umbrella supervisor is required to be independent of partisan politics and the congressional appropriations process. Moreover, the umbrella supervisor must have sufficient stature in financial markets in order to attract and retain qualified staff. It is unlikely that a stand-alone agency, even in the broad and deep financial markets of the United States, would meet both of the above conditions, for how would such an entity be funded other than by congressional appropriations? After all, by design, the umbrella supervisor would conduct few, if any, examinations, so there would be no exam fees to rely on and, unlike the Fed and the FDIC, there would be no portfolio of government securities from which earnings could be used to support its operation. Hence, the umbrella supervisory function would need to be housed in an existing agency, a new financial regulatory agency, or the central bank.

Why might the Federal Reserve be a natural choice to be the umbrella supervisor? The short answer—because Congress delegated the role to the Fed in GLBA and it is a natural extension of the Fed's role as regulator of bank holding companies—is an unsatisfying response, providing no explanation as to why the central bank is a better choice for this role than a federal bank regulatory agency or even the SEC. However, an economic case can be made for housing the umbrella supervisory function at the Fed. First, the Fed's responsibility to manage macroprudential risks—including concerns for financial stability and the integrity of the payments system—suggests that there may be economies of scope between central banking functions and umbrella supervision. In other words, the types of information the Fed needs to carry out its mission include financial market and financial firm information that an umbrella supervisor would collect and consolidate. In addition, the existence of the Federal Reserve is not contingent on its role as a functional supervisor. Consequently, any conflicts of interest between an agency's role as a functional supervisor and its role as umbrella supervisor should be less at the central bank. This, in turn, should facilitate the cooperation between the umbrella supervisory agency and functional regulators so important to the success of financial holding companies.

■ Recommended Readings

Ed Young. 1993. *Seven Blind Mice*, New York, N.Y.: Philomel Books.

For a discussion of enterprise-wide risk management in banking companies, see:

Susan Schmidt Bies. 2004a. "Enterprise Perspectives in Financial Institution Supervision." Remarks at the University of Connecticut School of Law, Connecticut Law Review Symposium, Hartford, Connecticut, October 21.

Susan Schmidt Bies. 2004b. "Using Enterprise-Wide Risk Management to Effectively Execute Business Strategies." Remarks at the Risk Management Association and Consumer Bankers Association Retail Risk Conference, Chicago, Illinois, July 16.

Federal Reserve Board letter SR 99-18, formally titled *Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles*, instructs banks to allocate capital on an economic basis, that is, to assign capital to business lines according to the risks they pose to the company. Available at <http://www.federalreserve.gov/boarddocs/SRLETTERS/1999/SR9918.HT>.

For more details on the Butcher banks, see:

Federal Deposit Insurance Corporation. (FDIC) 1998. "Managing the Crisis: The FDIC and RTC Experience: Chronological Overview." Available at <http://www.fdic.gov/bank/historical/managing/Chron/index.html> (accessed 01/04/05).

For more on the pros and cons of regulatory consolidation, including comparisons with other countries, see:

Charles A.E. Goodhart. 2000. "The Organisational Structure of Banking Supervision," FSI Occasional Papers, No. 1, November.

Charles A.E. Goodhart, and D. Schoenmaker. 1992. "Institutional Separation between Supervisory and Monetary Agencies," *Giorn. Econ*., pp. 9–12, 353–439.

Alan Greenspan. 1994. "The Views of the Board of Governors of the Federal Reserve on the Consolidation of Bank Supervision and Regulation." Banking Industry Regulatory Consolidation Hearings before the Committee on Banking, Housing, and Urban Affairs. U.S. Senate, S. Hrg. 103–692, pp. 130–56.

Joseph G. Haubrich. 1996. "Combining Bank Supervision and Monetary Policy," Federal Reserve Bank of Cleveland, *Economic Commentary* (November).

Joao A. C. Santos. 1998. "Securities Activities of Banking Conglomerates: Should They Be Regulated?" *Cato Journal* 98, Spring/Summer, pp. 93–08.

United States General Accounting Office. 2004. "Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure." Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, October.

Footnotes

1. See http://banking.senate.gov/conf/somfinal.htm.

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