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Does monetary policy affect the central bank's role in bank supervision?

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Abstract

This paper examines whether monetary policy responsibilities alter the central bank's role as a bank supervisor. The analysis focuses on the United States, where the Federal Reserve System shares supervisory duties with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation. Among the three institutions, the Fed is the only one responsible for monetary policy. Hence, the Fed's supervisory behavior—as captured by formal actions—is compared with the behavior of the other two agencies. The results suggest that the Fed's monetary policy responsibilities do alter its bank supervisory behavior: indicators of monetary policy affect the supervisory actions of the Fed, but do not affect the actions of the other two agencies.

JEL classification: E52; E58; G21; G28

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1. Introduction

In most countries, the central bank performs an important role in the management of the financial system. However, since the main task of the central bank is to maintain price stability, the assignment of other "optional tasks," such as bank supervision, has been subject to debate amongst academics and policymakers for several years. For example, policymak-

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ers in the United Kingdom, Japan, and several Scandinavian countries recently removed their central bank from its role in bank supervision, while (after a long debate) the European Central Bank was given no supervisory responsibilities. In the United States, where the Federal Reserve System has only partial responsibility for the supervision of banks, there were various proposals to the Congress to consolidate all supervisory duties under a new single federal regulator, separate from the Federal Reserve.

In the literature, several arguments have been developed against and in favor of combining the two functions under the same agency.[1] These arguments assume that in one way or another the central bank's supervisory duties affect monetary policy and vice versa. To date, however, there is little empirical evidence establishing the existence of such cross-effects, since data on bank supervision has been—and for the most part is still—confidential in most countries. Given the data limitations, most of the early studies provide only *indirect* evidence of such cross-effects.

For example, Heller (1991) and Goodhart and Schoenmaker (1992) compare the inflation rates achieved by central banks with and without bank supervisory duties. They find that countries with central banks that have supervisory duties experience on average higher inflation rates, and interpret this as evidence supporting the "conflict of interest" hypothesis. However, higher inflation rates under a combined regime are not necessarily the result of the central bank being distracted by supervisory considerations. Moreover, cross-country comparisons using descriptive statistics are naturally impaired by differences across countries in the structures of their financial systems as well as differences in the timing and magnitude of their business cycles.

This paper examines whether monetary policy duties affect the central bank's role in bank supervision, and if so, how? This question is addressed by exploiting the segmented structure of the US bank regulatory and supervisory system. Specifically, all insured commercial and savings banks in the United States have one of the following agencies as their primary federal supervisor: the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), or the Federal Reserve System (Fed). While the Fed's primary responsibility is to conduct monetary policy, the other two agencies have no such duty. Hence, using the FDIC and the OCC as a control group, the supervisory behavior of the Fed is compared with the behavior of the other two agencies. The analysis focuses on a particular aspect of bank supervision: the imposition of formal regulatory actions (i.e., cease and desist orders and written agreements) against banks in financial distress. This is an important aspect of bank supervision for which data can be constructed using publicly-available information and for which the general procedures and criteria of imposition provide a common basis for comparison.[2]

In order to perform this comparison, a unique and rich data set is created. Information collected from the formal action documents is combined with bank-level indicators of financial performance (constructed using the Call Report Data) and indicators of the ag-

[1] See, for example, Di Noia and Di Giorgio (1999), Goodhart and Schoenmaker (1992, 1995), Heller (1991), Haubrich (1996), Peek et al. (1999). A recent paper by Barth et al. (2003) provides (among other things) a comprehensive review of this literature.

[2] The procedures of imposition of formal actions as well as how a bank's primary supervisor is determined are discussed extensively in the section on methodology.