Federal Banking Regulators' Competition in Laxity: Evidence from CRA Audits

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The U.S. banking industry has three federal regulators in addition to the 50 state regulators. Through choices regarding its chartering source, joining the Federal Reserve System, and having deposit insurance, a bank also selects which office or agency serves as its primary regulator. Federal regulators gain status and authority from the number of banks over which they have primary supervision. It has long been suspected, therefore, that they compete with each other to entice banks to make choices that increase the number of banks reporting to them. This competition which includes less stringent enforcement and broad interpretation of the laws as favored by the banks is known as competition in laxity. The Community Reinvestment Act (CRA) is enforced by each of the three federal banking regulators. Since 1990, their ratings of banks' CRA performance have been published. This published data provides an opportunity to test accuracy of the competition in laxity theory. (JEL L60)

Introduction

The federal regulatory structure responsible for supervising American banks is an outgrowth of federalism. It reflects the dual power accorded in the Constitution to the federal government along with the governments of the several states to charter corporations, including banks.

Oversight of the U.S. banking industry is divided among four separate regulatory bodies, each of which has primary responsibility for a distinct segment of the banking community: 1) The Office of the Comptroller of the Currency (OCC)—federally chartered or national banks; 2) The Federal Reserve Board (Fed)—state chartered, member banks and all bank holding companies; 3) The Federal Deposit Insurance Corporation (FDIC)—state chartered, nonmember, federally insured banks; and 4) various state regulators—state chartered, nonmember banks which have no federal insurance [Kettl, 1991, p. 443]. If this number of regulators was insufficient to confuse the average citizen, Congress added the Office of Thrift Supervision to regulate the thrift industry after the savings and loan crisis.

Through the selection of a federal or state charter, banks determine whether or not they will be regulated by the OCC. State chartered banks are able to avoid OCC supervision and can further bypass the Fed by not becoming members of the Federal Reserve System. Although state chartered banks also can theoretically avoid all federal supervision—including that of the FDIC—by not paying for federal deposit insurance, there are almost no remaining domestic banks that have selected this option. It should be noted, however,

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that most foreign banks in the U.S. have avoided federal banking oversight to a considerable extent by choosing state charters, remaining outside the Federal Reserve System and avoiding retail banking which requires federal deposit insurance.

Hypothesis

The ability of the regulatees, namely the banks, to determine their primary regulator has played havoc with the ability and willingness of the latter to apply a tight rein on the former. Historically, the various banking regulators have sought to protect their clientele through relaxed enforcement of the banking laws. Additionally, the federal regulators have sought periodically to enhance their appeal to banks supervised by other regulators in the hope that some banks would "forum shop" in order to gain a friendlier primary regulator of choice [Dennis, 1978, p. 50]. This regulatory practice is known as a "competition in laxity" [Kettl, 1991, p. 443].

During the savings and loan crisis of the late 1980s, the public and Congress grew concerned about the strength and security of the banking industry, the adequacy of the banking insurance fund, and the stringency of enforcement of banking laws. Criticism of the industry increased in reaction to its request for its power to be expanded beyond traditional banking into areas such as writing insurance and underwriting securities and for its geographic reach to be broadened through interstate branching and banking. As part of this criticism, several plans were put forward to consolidate the federal banking regulators and eliminate the competition in laxity.

In an attempt to retain or expand their regulatory turf and authority in the face of a movement to overhaul the banking regulatory structure, the major banking regulators initially appeared to replace their competition in laxity with a competition in severity. By so doing, they each sought to demonstrate their diligence, seriousness of purpose, and toughness to gain public and Congressional support for the advancement of their own position in hopes of becoming the most powerful among the several banking regulators.

Our hypothesis, however, is that this new direction was short-lived. Differing interpretations, applications, and enforcement that each of the banking regulators has given to the Community Reinvestment Act (CRA) in audits conducted from July 1, 1990—when public disclosure of them became a requirement—through December 31, 1995—the last date for which CRA audit results are currently available—reveals that old habits die slowly and that the federal banking regulators have returned to a competition in laxity.

History of the CRA

Enacted on October 12, 1977, the Housing and Community Development Act sought to expand basic public housing, urban renewal, and post-World War II mortgage insurance and "to rearrange the funding formulas for the multipurpose community development and action grant programs instituted in the 1960s and early 1970s" ["The