THE WALL STREET JOURNAL.
WSJ.com

JANUARY 23, 2012, 3:44 PM ET

State Bank Regulators More Lenient Than Federal Counterparts

State banking regulators are far more lenient supervisors than their federal counterparts, with federal examiners about twice as likely to downgrade a commercial bank's supervisory rating, according to a new study.

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The inconsistent application of existing banking regulation has a tangible negative impact, the paper argues, because those states with the most lenient state regulators had higher rates of bank failures over the 15 year-period the study examined. Moreover, federal exams resulted in far more substantial changes at banks, with institutions reporting higher capital ratios, drops in profitability and more delinquent and nonperforming loans on their balance sheets — evidence of federal examiners flexing their muscle to force banks to make changes.

At the same time, the authors didn't find any evidence that stricter regulation caused banks to hand out fewer loans — suggesting that the tougher approach taken by federal regulators didn't carry a cost to the economy.

The paper's findings comes as the U.S. is overhauling much of its financial regulatory architecture, but the 2010 Dodd-Frank law didn't really alter the dual banking system that has been in place since the 19th century. **Amit Seru**, professor at the **University of Chicago**'s Booth School of Business and co-author along with **Sumit Agarwal** of the Chicago Fed, **David Lucca** of the New York Fed and **Francesco Trebbi** of the **University of British Columbia**, said the findings caution that policymakers may need to focus more on who is carrying out the new rules once they're written.

"Dodd-Frank is all about, 'We should allow banks to do these tasks,' but then we don't spend as much time thinking carefully about who should be regulating these tasks and does it really matter who does," said Mr. Seru.

The study found that even with a very standardized set of rules — in this case safety-and-soundness examinations that result in a numerical score given to each bank — two different regulatory institutions consistently come up with very different conclusions about the health of an individual bank, even when they're looking at the same bank within a very short period of time.

In order to compare regulators, the study looked at state-chartered banks, which by law are examined at regular, alternating intervals by both state and federal bank regulators. The fixed rotation means that there will be only a 12- or 18-month gap between the state and federal exams, which is generally not enough time for a bank to suffer a serious change in health. And the degree of difference between state and federal exams over a 15-year-period was just too striking for that time difference to matter, said Mr. Seru. The study used Federal Reserve data covering the years 1996 through 2010.

The study, to be published by the **National Bureau of Economic Research**, sought to see whether there was empirical evidence to support anecdotal accounts of inconsistent oversight hampering the effectiveness of regulations. Anecdotal exhibit A: The collapse of **Washington Mutual Bank**, which, the study notes, a formal Senate inquiry concluded was due in large part to a turf war between two regulators — the **Office of Thrift Supervision**, which found problems at the bank but didn't move to sanction it, and the **Federal Deposit Insurance Corp.**, which thought more aggressive action needed to be taken. Dodd-Frank eliminated the OTS, which was widely faulted for being too-cozy with the banks it oversaw in the lead up to the financial crisis.

The take-away for today, said Mr. Seru: "If we are going to make regulatory changes, make the regulation system more and more complex, and then have multiple regulators with overlapping jurisdictions taking actions on these, we should not expect quick actions."