Subsidiarity in Internal Structures of Financial Institutions

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(working draft)

"I recently tried to refinance my mortgage, and I was unsuccessful in doing so," Ben Bernanke, Former Chairman of the Federal Reserve, October 2014

Ben Bernanke's inability to refinance his mortgage is a dramatic instantiation of the complete dehumanization of mortgage underwriting in America. Any reasonable person would have prudentially determined that Mr. Bernanke, despite his recent career change, can still responsibly service the mortgage on this three bedroom Washington DC house. A computer, however, which necessarily lacks prudence, weighed Mr. Bernanke's recent employment instability differently and denied the application.

Ironically, the automated process that denied Chairman Bernanke's refinancing application is in part the fruit of the Federal Reserve's effort make credit underwriting fair. Bank regulators at the Federal Reserve and other government agencies have sought to reduce human fallibility and increase accountability by systematizing the underwriting decision. Specifically, the regulatory demand for a fully auditable paper trail intended to ensure the transparency and fairness of each underwriting decision has encouraged systems that remove human judgment.

With an exacting account of every credit decision having become the norm, decisions which allow for judgment attract extraordinary scrutiny. American auto loans, for instance, most of which are still originated by unregulated car dealers have come under intense scrutiny by regulators concerned that human bias impacts the application process. Even automated credit scoring models that differ from the Fed's own models have been cause for regulatory concern.

While many regulators defend aggressive systematization as the only way to manage our undercapitalized, concentrated, and culturally troubled banking sector, we should remain open to a better long-term solution. The obvious alternative is a return to a well-capitalized and decentralized banking system that would not invite such heavy regulation.

In practice, however, moving in this direction will prove extraordinary difficult. While there are a variety of ways to better capitalize banks and to decentralize the banking sector, all of these solutions will be vigorously opposed by the large, undercapitalized banks that dominate the todays banking system.

A more plausible solution involved allowing asset light financial intermediaries to perform more bank-like functions. The technology which has been used to centralize and dehumanize underwriting equally be used to intermediate credit decision outside of the banking system in a way that creates none of the systematic financial risks of banking.

Take the peer to peer lending systems for example. Without taking loans and deposits onto their balance sheets, these institutions perform the essential underwriting function of a bank in a very human fashion. If regulators allowed such institutions to offer current accounts, they would quickly take market share from the banking system. This simple step would allow savers to effectively opt out of the over-regulated banking system while preserving their ability to conduct the normal financial transactions of life.

The growth of asset light financial intermediaries such as peer to peer lenders entails no concentration of risk financial risk and consequently no systematic financial risks for regulators to worry about. Regulators would, however, need to give up their ability to monitor all financial transactions to foster the rapid growth of this banking alternative- for such regulations create an impossible burden for systems organized around distributed decision making.