Regulation of the Banking System and the Financial Services Industry

Regulation in Banking

- The Glass-Steagall Act made the banking sector a highly regulated industry
- By the 1970s, many believed that the economy was overregulated
  - led to a deregulation movement in many industries
- After deregulation, some industries experienced severe stresses and failures
  - some blamed deregulation

Regulation in Banking

- By the late 1990s, banks had recovered from previous difficulties and made record profits
- The early 2000s proved to be a more difficult time, but by 2004 banks had rebounded from any difficulties

Why Regulate?

- There are two objectives of regulation
  - competition
  - efficiency
- These two objectives may be at odds with one another
  - "free to compete" $\Rightarrow$ "free to fail"

Why Regulate?

- Regulations were deemed necessary because the trade-off between high returns for net lenders versus safety and soundness
  - FIs earn higher returns by assuming more risks
    - in the process of assessing the expected costs associated with the increased risk, the FI will consider only the costs to stockholders, creditors, and depositors
    - may ignore impacts on economy at large

Effects of Regulation

- Regulations encouraged specialization
  - limitations on portfolios compartmentalized FIs into specialties
    - insurance companies would specialize in insurance
    - banks would specialize in banking
  - these limitations have fallen and FIs have moved across specializations
    - 1999 legislation allowed full integration of banking, securities, and insurance firms

Effects of Regulation

- Regulations can focus on financial products or financial institutions
  - stocks bonds, and futures are regulated
  - banks, S&Ls, and insurance companies are regulated
- These products and institutions can be regulated by more than one agency

Current Regulatory Structure

- The regulatory structure of the financial services industry is in a process of ongoing change
  - the ongoing evolution of the industry results in new products and services, technological changes in the delivery of services, and the globalization of financial markets
    - changes in the system always lead to concerns about the adequacy of regulation

Deregulation in the Early 1980s

- Banks adapted to regulation by developing new types of liabilities and creating holding companies
- As these innovations weakened the effectiveness of regulations, Congress decided to deregulate the financial services industry
  - landmark legislation occurred in 1980 and again in 1982

Deregulation in the Early 1980s

- Depository Institutions Act and Monetary Control Act of 1980 (DIDMCA)
  - deregulation
    - Regulation Q ceilings were phased out
    - asset and liability powers of banks and thrifts were expanded
  - monetary control
    - all depository institutions were subject to reserve requirements
    - reserve requirements were to be the same on particular deposits across institutions

Deregulation in the Early 1980s

- Depository Institutions Act and Monetary Control Act of 1980 (DIDMCA)
  - put some explicit price competition back into banking and permitted competition among FIs
  - strengthened the effectiveness of the regulatory process and expanded the powers of the Fed

Deregulation in the Early 1980s

- Garn-St. Germain Depository Institutions Act of 1982
  - allowed depository institutions to offer two types of deposit accounts designed to compete directly with money market mutual funds
    - money market deposit accounts
    - super NOW accounts
  - this has led to competition among and between FIs

International Capital Standards

- Until 1980, banks were free to establish their own capital requirements
- In the early 1980s, regulators switched their focus to stricter capital requirements

International Capital Standards

- In 1988, the U.S. and 11 other countries entered into the Basel Accord
  - established uniform international capital standards for banks
    - specified the amount of capital that banks must hold relative to assets

International Capital Standards

- The standard was stricter than that imposed on U.S. banks at the time and involved risk-based capital standards
  - the amount of capital a bank was required to hold was based on the measurable riskiness of its assets relative to its liabilities
  - many banks had to alter their behavior as a result of this new standard

Regulation in Response to Financial Crisis

- The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) was signed into law in 1989
  - passed in response to the S&L crisis of the 1980s
  - was an attempt to increase regulation after the deregulation of the early 1980s

Regulation in Response to Financial Crisis

- Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)
  - created the Savings Association Insurance Fund (SAIF) which replaced FSLIC
  - created the Office of Thrift Supervision (replaced the Federal Home Loan Bank Board) and the Resolution Trust Corporation (temporary)
  - deposit insurance was made a full faith and credit obligation of the federal government

Regulation in Response to Financial Crisis

- Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)
  - restricted the investments of S&Ls by limiting commercial mortgage lending and phasing out junk bond investments
  - imposed capital requirements on S&Ls

Tightening Up Deposit Insurance

- Deposit insurance leads to more risk taking
  - moral hazard problem
    - if the FI loses funds when taking greater risks, the depositors will still get their funds back
- Congress responded to this problem by passing the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991

Tightening Up Deposit Insurance

- Federal Deposit Insurance Corporation Improvement Act (FDICIA)
  - scaled the insurance premiums to the risk exposure of the bank or thrift
  - limited coverage of regular accounts to $100,000
  - required the FDIC to use the least costly method of resolving any insolvency
    - must compare the costs of the payoff method with those of the purchase and assumption method