Bank Regulation (3/22/2011) Econ 310-008

Definitions

- ***thrift institutions (thrifts)*** – savings and loan associations, mutual savings banks, and credit unions
- ***credit unions*** – cooperative lending institutions organized around a particular group (e.g., union members, employees, etc.)
- ***closed end investment company*** – stock owned: issues fixed # of shares and has a secondary market (e.g., stock on exchange)
- ***open end investment company*** – mutually owned: variable # of shares, not saleable on secondary market, direct link between share/asset value (e.g., mutual fund, hedge fund)

Principles

- The lines between thrifts and commercial banks have become blurred since 1980s.
- Thrifts have been all but eliminated by the Dodd-Frank Act of 2010. Thrifts are now regulated by the Comptroller of the Currency, the Federal Reserve, and the FDIC.
- In the 1970s banks were hurt by interest rate caps and disintermediation, so they called for deregulation.
- Deposit insurance created a moral hazard problem (fixed premiums irrespective of risk) leading to risky investments. S&Ls had higher interest rate risk and a lower equity cushion. When insolvent they would gamble even more to get even again (zombie S&Ls).
- In the late 1980's many S&Ls failed due to a moral hazard problem with deposit insurance, higher interest rate risk with home loans, and a lower equity cushion.
- The Federal Savings and Loan Insurance Corporation (FSLIC) did not have enough money to pay out deposit insurance claims for S&Ls.
- The Volcker Rule prohibits banks from proprietary trading (trading their own money instead of client money), prohibits banks from investing in a hedge funds, and limits the liabilities banks can hold.

Pre-1970 division

- commercial banks
  - monopoly on checking accounts
  - more diversified
- thrifts
  - could pay higher interest rates
  - mostly mortgages
- investment banks
  - could invest in equity securities

S&Ls and Savings Banks

- assets: focused on mortgages
- liabilities: focused on savings accounts
- mutually owned (not shareholder owned)
  - eliminates debt/equity distinction
  - decreases moral hazard
- regulated separately from other banks

Credit Unions

- type of mutual
- 1 vote regardless of # of shares
- volunteer management
- usually small
- qualify as non-profits
- exempt from corporate income tax
- regulated separately from other banks

Pre-1989 regulation

- S&Ls
  - FHLB Board (charter)
  - FHLBS (LOLR)
  - FSLIC (insurance)
- banks
  - Comptroller of Currency (charter)
  - Federal Reserve (LOLR)
  - FDIC (insurance)

Office of Thrift Supervision (OTS)

- analogous to Comptroller of the Currency
- national charters and regulations for thrifts
- created in 1989
  - was Federal Home Loan Bank Board
- abolished in 2010

Federal Savings & Loan Insurance Corporation

- FSLIC is analogous to FDIC
- federal deposit insurer to S&Ls
- abolished in 1989
  - insolvent due to S&L crisis
  - S&L deposit insurance went to FDIC

Federal Home Loan Bank System (FHLBS)

- analogous to Federal Reserve
- lender of last resort to S&Ls
- 12 regions
- dual chartering (national/state)

Federal Reserve Act of 1913

- created the Federal Reserve

McFadden Act of 1927

- prohibited interstate branch banking
- national and state banks on equal footing

Banking Act of 1933 (Glass-Steagall Act) and 1935

- created the FDIC
- separated banking and securities industries
- prohibited interest on checkable deposits
- checkable deposits: commercial banks only
- regulation Q: interest-rate ceilings deposits

Securities Act 1933 / Securities Exchange Act 1934

- required financial reports for investors
- prohibited securities misrepresentations
- Securities and Exchange Commission (SEC)

Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980

- gave thrifts wider latitude in activities
- approved NOW and sweep accounts
- phased out interest-rate ceilings (reg Q)
- imposed uniform reserve requirements
- eliminated usury ceilings on loans
- increased deposit insurance to $100,000

Depository Institutions Act of 1982 (Garn-St. Germain Act)

- emergency powers for FDIC and FSLIC
- depository institutions can offer MMDAs
- granted thrifts wider latitude in lending

Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989

- funds to resolve S&L failures
- eliminated FSLIC and FHLB Board
- created Office of Thrift Supervision
- created Resolution Trust Corporation
- raised deposit insurance premiums
- re-imposed restrictions on S&L activities

Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991

- recapitalized the FDIC
- limited “too big to fail” policy
- established risk-based premiums for FDIC
- increased examinations, capital & reporting
- Fed supervision of foreign banks

Riegle-Neal Interstate Branking and Branching Efficiency Act of 1994

- allowed interstate branch banking
- allowed intrastate branch banking

Gramm-Leach-Bliley Financial Services Modernization Act of 1999

- removed separation of banking and securities

Sarbanes-Oxley Act of 2002

- Public Company Accounting OversightBoard
- prohibits certain conflicts of interest
- CEO/CFO certify financial statements

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

- consolidates regulatory agencies
- eliminates thrift charter
- creates Financial Stability Oversight Council
- Bureau of Consumer Financial Protection
- Volcker rule
- regulates derivatives
- regulates hedge funds