Chapter 11

Economic Analysis of
Banking Regulation

How Asymmetric Information Explains Banking Regulation

1. Government safety net and deposit insurance
   - prevents bank runs due to asymmetric information
   - the FDIC can handle a failed bank through:
     - *payoff method:* pay depositors, then recover bank assets
     - *purchase and assumption method:* reorganize the bank
   - creates moral hazard incentives for banks to take on too much risk
   - creates adverse selection for bank managers
   - *Too-Big-to-Fail* increases moral hazard for big banks (or due to consolidation)

How Asymmetric Information Explains Banking Regulation (cont.)

2. Restrictions on asset holdings
   - reduces moral hazard of too much risk taking (no stocks, diversification etc.)
3. Bank capital requirements
   - *leverage ratio* = capital/assets – needs to be higher than 5%
   - *Basel Accord*: bank capital has to be at least 8% of risk-weighted assets
   - consequences:
     - reduces moral hazard: banks have more to lose when they have higher capital
     - higher capital means more collateral for FDIC

How Asymmetric Information Explains Banking Regulation (cont.)

4. Bank (prudential) supervision: chartering and examination
   - reduces adverse selection problem of risk takers or crooks owning banks
   - reduces moral hazard by preventing risky activities
5. New trend: assessment of risk management
6. Disclosure requirements
   - better information reduces asymmetric information problem

How Asymmetric Information Explains Banking Regulation (cont.)

7. Consumer protection
   - standardized interest rates (APR) – “truth in lending”
   - prevent discrimination: e.g., CRA
8. Restrictions on competition to reduce risk-taking
   - branching restrictions
   - separation of banking and securities industries in the past: Glass-Steagall

International banking regulation
   - bank regulation abroad similar to the US
   - problem regulating international banking

Major Banking Legislation in U.S.

Table 1 Major Banking Legislation in the United States in the Twentieth Century

Federal Reserve Act (1913)
Created the Federal Reserve System

McFadden Act of 1927
Effectively prohibited banks from branching across state lines
Put national and state banks on equal footing regarding branching

Banking Act of 1933 (Glass-Steagall) and 1935
Created the FDIC
Separated commercial banking from the securities industry
Prohibited interest on checkable deposits and restricted such deposits to commercial banks
Put interest-rate ceilings on other deposits

(continues)

Major Banking Legislation in U.S. (cont.)

Table 1 Major Banking Legislation in the United States in the Twentieth Century *(continued)*

Bank Holding Company Act and Douglas Amendment (1956)
Clarified the status of bank holding companies (BHCs)
Gave the Federal Reserve regulatory responsibility for BHCs

Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980
Gave thrift institutions wider latitude in activities
Approved NOW and sweep accounts nationwide
Phased out interest rate ceilings on deposits
Imposed uniform reserve requirements on depository institutions
Eliminated usury ceilings on loans
Increased deposit insurance to $100,000 per account

Depository Institutions Act of 1982 (Garn–St. Germain)
Gave the FDIC and the FSLIC emergency powers to merge banks and thrifts across state lines
Allowed depository institutions to offer money market deposit accounts (MMDAs)
Granted thrifts wider latitude in commercial and consumer lending

Competitive Equality in Banking Act (CEBA) of 1987
Provided $10.8 billion to the FSLIC
Made provisions for regulatory forbearance in depressed areas

Major Banking Legislation in U.S. (cont.)

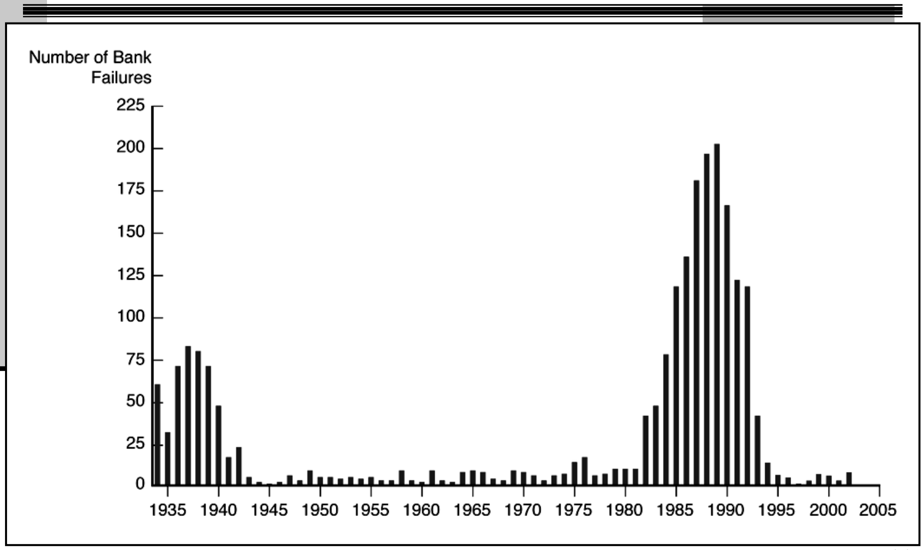
Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989
Provided funds to resolve S&L failures
Eliminated the FSLIC and the Federal Home Loan Bank Board
Created the Office of Thrift Supervision to regulate thrifts
Created the Resolution Trust Corporation to resolve insolvent thrifts
Raised deposit insurance premiums
Reimposed restrictions on S&L activities

Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991
Recapitalized the FDIC
Limited brokered deposits and the too-big-to-fail policy
Set provisions for prompt corrective action
Instructed the FDIC to establish risk-based premiums
Increased examinations, capital requirements, and reporting requirements
Included the Foreign Bank Supervision Enhancement Act (FBSEA), which strengthened the Fed's Authority to supervise foreign banks

Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994
Overturned prohibition of interstate banking
Allowed branching across state lines

Gramm-Leach-Bliley Financial Services Modernization Act of 1999
Repealed Glass-Steagall and removed the separation of banking and securities industries

Bank Failures



Why a Banking Crisis in 1980s?

- Early stages
  - decreasing profitability: banks take risk to keep profits up
  - deregulation in 1980 and 1982, more opportunities for risk taking
  - innovation of brokered deposits enabled circumvention of the $100,000 insurance limit
  - $\pi\uparrow$, $i\uparrow$, net worth of S&Ls $\downarrow$, leading to:
    - more insolvencies
    - higher incentives for risk taking

Result: More failures and more risky loans

Why a Banking Crisis in 1980s? (cont.)

- Later stages: *regulatory forbearance* (e.g., include *goodwill* in capital)
  - regulators allow insolvent S&Ls to operate because
    - insufficient funds
    - sweep problems under rug
    - FHLBB cozy with S&Ls
  - huge increase in moral hazard for *zombie* (i.e., functioning, but insolvent) S&Ls
  - zombies hurt healthy S&Ls:
    - raise the cost of funds
    - lower loan rates
  - outcome: huge losses

Political Economy of S&L Crisis (Principal-Agent Problem)

- Politicians were influenced by S&L lobbyists rather than by the public
  - deny funds to close S&Ls
  - legislation to relax restrictions on S&Ls
  - Competitive Bank Equality Act (CEBA) of 1987 had inadequate amounts for bailout
- Regulators influenced by politicians and willing to avoid blame
  - loosened capital requirements
  - regulatory forbearance
  - short-staffed – reduced on-site examinations

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

- the most important legislation in the industry since the ’30s
- sets up a new regulatory structure:
  - Office of Thrift Supervision as new regulator
  - FDIC takes over FSLIC fund
- Resolution Trust Corporation (RTC) created and given funds to close insolvent S&Ls: cost of $100-$200 billion
- core capital requirement increased from 3% to 8%
- reregulation: asset restrictions like before 1982

Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991

- FDIC recapitalized with loans and higher premiums
- reduced the scope of deposit insurance and “too-big-to-fail” (banks must be closed using least costly method)
- prompt corrective action provisions, based on capital-classification of banks
- risk-based premiums
- annual examinations and stricter reporting
- enhances Fed powers to regulate international banking

Banking Crises Worldwide

Cost of Banking Crises in Other Countries

Table 2 The Cost of Rescuing Banks in Several Countries

Date	Country	Cost as a % of GDP
1980–1982	Argentina	55
1997–ongoing	Indonesia	50
1981–1983	Chile	41
1997–ongoing	Thailand	33
1997–ongoing	South Korea	27
1997–ongoing	Malaysia	16
1994–1997	Venezuela	22
1995	Mexico	19
1990–ongoing	Japan	20
1989–1991	Czech Republic	12
1991–1994	Finland	11
1991–1995	Hungary	10
1994–1996	Brazil	13
1987–1993	Norway	8
1998	Russia	5–7
1991–1994	Sweden	4
1984–1991	United States	3