Lecture 5b: Banking & Bank Regulation

Dual Banking System

→ historically banks chartered by the state in which they operated

→ but with the National Bank Act of 1863 banks could get a charter from the Office of the Comptroller of the Currency (OCC)

→ also: Office of Thrift Supervision (OTS)

→ Federal Reserve System (central bank) created in 1913 & all federally chartered banks were required to join; state banks had option to join or not (but most did not because membership expensive)

→ Federal Deposit Insurance Corp (FDIC) created in 1933 (response to Great Depression) to prevent depositor losses during a bank failure

- all members of Federal Reserve System had to join
- non-Fed member banks had option to join almost all did
- deposit insurance

→ Glass-Steagall (1933) repealed in 1999

- another response to Great Depression
- created a separation between commercial & investment banking

Prior to Glass Steagall banks & brokers often indistinguishable
- bank holds stock
- stock mkt crash
- bank assets wiped out & cannot meet obligations to its depositors

SAFETY and SOUNDNESS

→ commercial banks would take deposits & make loans

→ investment banks would underwrite (and deal in) corporate securities

→ commercial banks still allowed to underwrite gov't securities

→ commercial banks could only purchase debt securities that their regulator approved

→ investment banks could not take deposits (or engage in other forms of commercial banking activities)

→ over time, banks began to find loopholes in the law & exploited them ("financial innovation") so the distinction betw/n commercial & investment banks began to blur

→ until repeal in 1999

"Financial Innovation"

- → response to changes in demand conditions
  - interest rate volatility
    - ⇒ interest rate risk
    - → adjustable rate mortgages
    - → financial derivatives
      - allows institutions to hedge
      - futures contracts

- → response to changes in supply conditions
  - information technology
    - → reduced transaction costs
      - credit cards feasible
      - debit cards feasible

think of a credit card as hundreds of little loans

- → electronic banking
  - ATMs
  - online banking
- → junk bonds
  - ability to gather information makes it easier to discern good vs bad risks

→ growth of commercial paper mkt

- enabled businesses to borrow short-term in securities mkts (as opposed to using bank as an intermediary)
- contributor – growth of money mkt mutual funds which need to hold liquid, high-quality, short-term assets such as commercial paper

→ securitization

- pools illiquid assets (e.g. residential mortgages, auto loans, etc.)
- ~~divides payments into tranches~~
- investors can buy senior, mezzanine or junior level tranch
- investors receive standardized payments like a bond

→ avoidance of regulations

→ reserve requirements act like a tax on deposits (when interest not paid on those reserves)

RESPONSE → money mkt mutual funds

- not deposits! (so not subject to reserve req't)
- allow you to write check

→ restrictions on interest paid on deposits

- if investor can get higher yield on security,
- then bank may lose deposits

RESPONSE → sweep accounts

- balances above a certain amount "swept out" of checking account + invested in overnight securities
- swept out funds no longer deposits + not subject to reserve req'ts + enable bank to pay interest on checking account
- made possible by information technology

→ Banks' share of funds provided to non-financial borrowers has shrunk

- from 40% of total credit advanced in 1974 to 30% in 2002

→ Banks' share of financial intermediary assets has shrunk, while the share belonging to pension funds + mutual funds has grown

→ Banks lost advantages on both sides of the balance sheet

in 1980s

- increase in inflation rate during 1970s meant other assets more attractive so banks lost deposits
- elimination of Reg Q ceilings on time deposit interest rates enabled banks to be more competitive when pursuing funds
- but forced banks to pay higher interest rates

- lost advantage in acquiring funds (liability side)

- businesses can now acquire funds in the commercial paper mkt to finance short-term credit needs
- rise of junk bond mkt

- lost advantage in use of funds (asset side) (because lost traditional borrowers)

- banks lost loan business to other financial institutions because computers can evaluate credit risk ← banks' traditional advantage

Branching restrictions & their decline

- ~~[illegible]~~ enabled many small banks to stay in existence
- but trend toward nationwide banking
- 1970s & 1980s — reciprocal arrangements between states allowed banks to cross state lines
- banks able to achieve economies of scale via Mergers & Acquisitions
  - → large up-front costs to develop the necessary information technology platforms
- 1994 — bank holding companies allowed to acquire banks in any state
- bank holding companies allowed to merge the banks they own
- thus enabling interstate branching

Repeal of Glass-Steagall

1999 → Gramm-Leach-Bliley repealed Glass-Steagall

→ securities + insurance firms could purchase banks

→ banks allowed to underwrite insurance + securities and allowed to engage in real estate activities

Regulatory:

→ states continue to regulate insurance

→ SEC has oversight over securities

→ OCC regulates bank subsidiaries engaged in underwriting of securities

→ Federal Reserve continues to oversee bank holding companies, which house:

- real estate activities
- insurance activities
- large securities activities

→ FDIC provides deposit insurance

Note: 5 different regulators

Oh, and banks can also be state-chartered so there is competition between state bank regulators + the OCC

→ Repeal of Glass-Steagall allows banks to become larger, more complex organizations, providing broad range of financial services

→ other countries

- universal banking (Germany, Netherlands, Switz.) no separation at all between the banking + securities industries
- British-style universal banking
  - legal subsidiaries more common
  - banks equity holdings of commercial firms less common
  - banking-insurance combination less common
- separation model
  - Japanese banks are allowed to hold substantial equity stakes in commercial firms
  - in US, they cannot
  - Note: if bank owns equity in firm X + if firm X in danger of failure, then bank under enormous pressure to lend to firm X RISK: BOTH FAIL

→ Eurodollars ≠ Euros

- Eurodollars are dollar-denominated deposits held in (European) banks
- most are time deposits
- held for financing int'l transactions
- held in countries that will not subject them to capital controls
- Eurodollar market an important source of funds for US banks (Some American banks even set up their own subsidiaries overseas for the purpose)

→ Basel Agreements

- internationalization of banking
- integration of world financial markets
- so need to standardize minimum capital requirements

→ Interesting Note

- when a foreign bank opens ~~[illegible]~~ subsidiary, branch or agency in the US it ~~[illegible]~~ can choose a state or federal charter