CHAPTER TWO

The Impact of Government Policy and Regulation on the Financial-Services Industry

Key Topics in This Chapter

- The Principal Reasons for Banking and Financial-Services Regulation
- Major Financial-Services Regulators and Laws
- The Riegle-Neal and Gramm-Leach-Bliley (GLB) Acts
- The Check 21, FACT, Patriot, Sarbanes-Oxley, Bankruptcy Abuse, Federal Deposit Insurance Reform, and Financial-Services Regulatory Relief Acts
- Emergency Economic Stabilization Act and the Global Credit Crisis
- FINREG is passed into law to avoid severe disruption in the financial system and deal with systemic rick
- Some Key Regulatory Issues Left Unresolved
- The Central Banking System
- Organization and Structure of the Federal Reserve System and Leading Central Banks of Europe and Asia
- Financial-Services Industry Impact of Central Bank Policy Tools

2–1 Introduction

Some people fear financial institutions. They may be intimidated by the power and influence these institutions seem to possess. Thomas Jefferson, third President of the United States, once wrote: "I sincerely believe that banking establishments are more dangerous than standing armies." Partly out of such fears a complex web of laws and regulations has emerged.

This chapter is devoted to a study of the complex regulatory environment that governments around the world have created for financial-service firms in an effort to safeguard the public's savings, bring stability to the financial system, and, hopefully, prevent abuse of financial-service customers. Financial institutions must contend with some of the heaviest and most comprehensive rules applied to any industry. These government-imposed regulations are enforced by federal and state agencies that oversee the operations, service offerings, performance, and expansion of most financial-service firms.

Regulation is an ugly word to many people, especially to managers and stockholders, who often see the rules imposed upon them by governments as burdensome, costly, and unnecessarily damaging to innovation and efficiency. But the rules of the game always seem to be changing—some financial-service regulations are being set aside or weakened and the free marketplace, not government dictation, is increasingly relied upon to shape and restrain what financial firms can do, especially in periods of prosperity. One prominent example in the United States was the 1999 Gramm-Leach-Bliley (Financial Services Modernization) Act, which tore down the regulatory walls separating banking from security trading and underwriting and from the insurance industry, allowing these different types of financial firms to acquire each other, dramatically increasing competition, but also adding greater volatility to the financial marketplace.

In contrast, the rules of the financial-services game tightened up when the global economy floundered. Financial firms were forced to adhere to more burdensome laws and regulations, raising their operating costs, as happened in the wake of the 2007–2009 credit crisis.

In this chapter we examine the key regulatory agencies that supervise and examine banks and their closest competitors. The chapter concludes with a brief look at monetary policy and several of the most powerful regulatory institutions in the world, including the Federal Reserve System, the European Central Bank, the Bank of Japan, and the People's Bank of China.

2–2 Banking Regulation

First, we turn to one of the most government regulated of all industries—commercial banking. As bankers work to supply loans, accept deposits, and provide other financial services to their customers, they must do so within a climate of extensive federal and state rules designed primarily to protect the *public interest*.

Filmtoid
What 2010 documentary narrated by Matt Damon portrays bankers and regulators as the "bad guys" for their roles in the financial crisis of 2008?
Answer: *Inside Job*

A popular saying among bankers is that the letters FDIC (Federal Deposit Insurance Corporation) really mean Forever Demanding Increased Capital! To U.S. bankers, at least, the FDIC and the other regulatory agencies seem to be forever demanding something: more capital, more reports, more public service, and so on. No new bank can enter the industry without government approval (in the form of a charter to operate). The types of deposits and other financial instruments sold to the public to raise funds must be sanctioned by each institution's principal regulatory agency. The quality of loans and investments and the adequacy of capital are carefully reviewed by government examiners. For example, when a bank seeks to expand by constructing a new building, merging with another bank, setting up a branch office, or acquiring or starting another business, regulatory approval must first be obtained. Finally, the institution's owners cannot even choose to close its doors and leave the industry unless they obtain explicit approval from the government agency that granted the original charter of incorporation.

To encourage further thought concerning the process of regulatory governance, we can use an analogy between the regulation of financial firms and the experiences of youth. We were all children and teenagers before growing physically, mentally, and emotionally into adults. As children and teenagers, we liked to have fun; however, we pursued this objective within the constraints set by our parents, and some kids had more lenient parents than others. Financial firms like to maximize shareholders' wealth (shareholders are having fun when they are making money); however, they must operate within the constraints imposed by regulators. Moreover, banks are in essence the "kids" with the strictest parents on the block.

Pros and Cons of Strict Rules

Why are banks closely regulated—more so than most other firms? A number of reasons can be given for this heavy and costly burden of government supervision, some centuries old.

First, banks are among the leading repositories of the public's savings, especially the savings of individuals and families. While most of the public's savings are placed in relatively short-term, highly liquid deposits, banks also hold large amounts of long-term savings in retirement accounts. The loss of these funds due to bank failure or crime would be catastrophic to many individuals and families. However, many savers lack the financial expertise or depth of information needed to correctly evaluate the riskiness of a bank or other financial-service provider. Therefore, regulatory agencies are charged with the responsibility of gathering and evaluating the information needed to assess the true condition of banks and other financial firms to protect the public against loss. Cameras and guards patrol bank lobbies to reduce the risk of loss due to theft. Periodic examinations and audits are aimed at limiting losses from embezzlement, fraud, or mismanagement. Government agencies stand ready to loan funds to financial firms faced with unexpected shortfalls of spendable reserves so the public's savings are protected.

Key Video Link
@ **http://wn.com/Why_no_bank_regulation_with_teeth_The_Real_News.com** see an interview with political scientist Thomas Ferguson, who shares his views of factors that limit bank regulation.

Banks are closely watched because of their power to create money in the form of readily spendable deposits by making loans and investments. Changes in the volume of money created by banks and competing financial firms appear to be closely correlated with economic conditions, especially the growth of jobs and the presence or absence of inflation. However, the fact that banks and many of their nearest competitors create money, which impacts the vitality of the economy, is not necessarily a valid excuse for regulating them. As long as government policymakers can control a nation's money supply, the volume of money individual financial firms create should be of no great concern to the regulatory authorities or to the public.

Banks and their closest competitors are also regulated because they provide individuals and businesses with loans that support consumption and investment spending. Regulatory authorities argue that the public has a keen interest in an adequate supply of credit flowing from the financial system. Moreover, where discrimination in granting credit is present, those individuals who are discriminated against face a significant obstacle to their personal well-being and an improved standard of living. This is especially true if access to credit is denied because of age, sex, race, national origin, or other irrelevant factors. Perhaps, however, the government could eliminate discrimination in providing services to the public simply by promoting more competition among providers of financial services, such as by vigorous enforcement of the antitrust laws, rather than through regulation.

Finally, banks, in particular, have a long history of involvement with federal, state, and local governments. Early in the history of the industry governments relied upon cheap bank credit and the taxation of banks to finance armies and to supply the funds they were unwilling to raise through direct taxation of their citizens. More recently, governments have relied upon banks to assist in conducting economic policy, in collecting taxes, and in dispensing government payments. This reason for regulation has come under attack recently, however, because banks and their competitors probably would provide financial services to governments if it were profitable to do so, even in the absence of regulation.

Key URL
News concerning bank regulation and compliance with current rules can be found at the American Bankers Association website at **www.aba.com/compliance**.

In the United States, banks are regulated through a **dual banking system**—*both* federal and state authorities have significant regulatory powers. This system was designed to give the states closer control over industries operating within their borders, but also, through

Insights and Issues

THE PRINCIPAL REASONS FOR GOVERNMENT REGULATION OF FINANCIAL FIRMS

- To protect the safety of the public's savings.
- To control the supply of money and credit in order to achieve a nation's broad economic goals (such as high employment and low inflation).
- To ensure equal opportunity and fairness in the public's access to credit and other vital financial services.
- To promote public confidence in the financial system, so that savings flow smoothly into productive investment, and payments for goods and services are made speedily and efficiently.
- To avoid concentrations of financial power in the hands of a few individuals and institutions.
- To provide the government with credit, tax revenues, and other services.
- To help sectors of the economy that have special credit needs (such as housing, small business, and agriculture).

However, regulation must be balanced and limited so that: (a) financial firms can develop new services the public demands, (b) competition in financial services remains strong to ensure reasonable prices and an adequate quantity and quality of service to the public, and (c) private-sector decisions are not distorted in ways that waste scarce resources (such as by governments propping up financial firms that should be allowed to fail).

The credit crisis of 2007–2009 suggested that financial regulation can have serious weaknesses, including lack of transparent oversight of the activities of key financial institutions. The Financial Reform Act of 2010 (FINREG) suggests a new era now may be underway, calling for closer, more extensive financial-sector regulation to reduce volatility and risk in the financial marketplace.

federal regulation, to ensure that banks would be treated fairly by individual states and local communities as their activities expanded across state lines. The key bank regulatory agencies within the U.S. government are the Comptroller of the Currency, the Federal Reserve System, and the Federal Deposit Insurance Corporation. The Department of Justice and the Securities and Exchange Commission also have important federal regulatory roles, while **state banking commissions** are the primary regulators of American banks at the state level, as shown in Table 2–1.

The Impact of Regulation—The Arguments for Strict Rules versus Lenient Rules

Although the reasons for regulation are well known, the possible impacts of regulation on the banking and financial-services industry are in dispute. One of the earliest theories about regulation, developed by economist George Stigler [5], contends that firms in regulated industries actually seek out regulation because it brings benefits in the form of monopolistic rents due to the fact that regulations often block entry into the regulated industry. Thus, some financial firms may lose money if regulations are lifted because they will no longer enjoy protected monopoly rents that increase their earnings. Samuel Peltzman [4], on the other hand, contends that regulation shelters a firm from changes in demand and cost, lowering its risk. If true, this implies that lifting regulations would subject individual financial-service providers to greater risk and eventually result in more failures.

Key URLs
If you are interested in exploring regulatory agencies from your home state or other U.S. states, enter the state's name and the words "banking commission" in a search engine. See, for example, the New York and California state banking commissions at **www.banking.state.ny.us** and **www.csbs.org**.

More recently, Edward Kane [3] has argued that regulations can increase customer confidence, which, in turn, may create greater customer loyalty toward regulated firms. Kane believes that regulators actually compete with each other in offering regulatory services in an attempt to broaden their influence among regulated firms and with the general public. Moreover, he argues that there is an ongoing struggle between regulated firms and the regulators, called the *regulatory dialectic*. This is much like the struggle between children (banks) and parents (regulators) over such rules as curfew and acceptable friends. Once regulations are set in place, financial-service managers will inevitably search to find ways around the new rules in order to reduce costs and allow innovation to occur. If they are successful in skirting existing rules, then *new* regulations will be created, encouraging

TABLE 2–1
Banking's Principal Regulatory Agencies and Their Responsibilities

Federal Reserve System
- Supervises and regularly examines all state-chartered member banks and bank holding companies operating in the United States and acts as the "umbrella supervisor" for financial holding companies (FHCs) that are now allowed to combine banking, insurance, and securities activities under common ownership.
- Imposes reserve requirements on deposits (Regulation D).
- Must approve all applications of member banks to merge, establish branches, or exercise trust powers.
- Charters and supervises international banking corporations operating in the United States and U.S. bank activities overseas.

Comptroller of the Currency
- Issues charters for new national banks.
- Supervises and regularly examines all national banks.
- Must approve all national bank applications for branch offices, trust powers, and acquisitions.

Federal Deposit Insurance Corporation
- Insures deposits of federally supervised depository institutions conforming to its regulations.
- Must approve all applications of insured depositories to establish branches, merge, or exercise trust powers.
- Requires all insured depository institutions to submit reports on their financial condition.

Department of Justice
- Must review and approve proposed mergers and holding company acquisitions for their effects on competition and file suit if competition would be significantly damaged by these proposed organizational changes.

Securities and Exchange Commission
- Must approve public offerings of debt and equity securities by banking and thrift companies and oversee the activities of bank securities affiliates.

Commodities Futures Trading Commission
- Monitors the use of derivative instruments (such as Futures, Options, and Swaps) by financial firms exposed to significant risk.

State Boards or Commissions
- Issue charters for new depository institutions.
- Supervise and regularly examine all state-chartered banks and thrifts.

financial managers to further innovate to relieve the burden of the new rules. Thus, the struggle between regulated firms and regulators goes on indefinitely. The regulated firms never really grow up. Kane also believes that regulations provide an incentive for less-regulated businesses to try to win customers away from more-regulated firms, something that appears to have happened in banking in recent years as financial conglomerates and other less-regulated financial firms have stolen away some of banking's best customers.

Concept Check

2–1. What key areas or functions of a bank or other financial firm are regulated today?

2–2. What are the *reasons* for regulating each of these key areas or functions?

2–3 Major Banking Laws—Where and When the Rules Originated

One useful way to see the potent influence regulatory authorities exercise on the banking industry is to review some of the major laws from which federal and state regulatory agencies receive their authority and direction. Table 2–2 lists the number of U.S. banks by their principal regulators.

TABLE 2–2
Regulators of U.S. Insured Banks (Showing Numbers of U.S. Banks Covered by Deposit Insurance as of 2009)

Source: Federal Deposit Insurance Corporation.

Types of U.S. Insured Banks	Number of U.S Insured Banks (as of 12/31/09)	Number of Branch Offices of Insured Banks (as of 12/31/09)
Banks chartered by the federal government:		
U.S. insured banks with national (federal) charters issued by the Comptroller of the Currency	1,448	43,158
Banks chartered by state governments:		
State-chartered member banks of the Federal Reserve System and insured by the Federal Deposit Insurance Corporation	840	14,505
State-chartered nonmember banks insured by the Federal Deposit Insurance Corporation	4,520	23,613
Total of All U.S. Insured Banks and Branches	6,808	81,276
Primary Federal Regulators of U.S. Insured Banks	**Number of U.S. Insured Banks under Direct Regulation**	
Federal Deposit Insurance Corporation (FDIC)	4,520	
Office of the Comptroller of the Currency (OCC)	1,448	
Board of Governors of the Federal Reserve System (BOG)	840	

Notes: The number of insured banks subject to each of the three federal regulatory agencies listed immediately above may not exactly match the numbers shown in the top portion of the table due to shared jurisdictions and other special arrangements among the regulatory agencies.

Factoid
What is the oldest U.S. federal banking agency?
Answer: The Comptroller of the Currency, established during the 1860s to charter and regulate U.S. national banks.

Meet the "Parents": The Legislation That Created Today's Bank Regulators

Key URL
To learn more about the Comptroller of the Currency explore "About OCC" at **www.occ.treas.gov/**.

National Currency and Bank Acts (1863–64)

The first major federal government laws in U.S. banking were the National Currency and Bank Acts, passed during the Civil War. These laws set up a system for chartering new national banks through a newly created bureau inside the U.S. Treasury Department, the Office of the **Comptroller of the Currency** (OCC). The Comptroller not only assesses the need for and charters new national banks, but also regularly examines those institutions. These examinations vary in frequency and intensity with the bank's financial condition. However, every national bank is examined by a team of federal examiners at least once every 12 to 18 months. In addition, the Comptroller's office must approve all applications for the establishment of new branch offices and any mergers where national banks are involved. The Comptroller can close a national bank that is insolvent or in danger of imposing substantial losses on its depositors.

Key URL
The supervision and examination of state-chartered member banks is the primary responsibility of the Federal Reserve System at **www.federalreserve.gov/banknreg.htm**.

The Federal Reserve Act (1913)

A series of financial panics in the late 19th and early 20th centuries led to the creation of a second federal bank regulatory agency, the **Federal Reserve System** (the Fed). Its principal roles are to serve as a lender of last resort—providing temporary loans to depository institutions facing financial emergencies—and to help stabilize the financial markets and the economy in order to preserve public confidence. The Fed also was created to provide important services, including the establishment of a network to clear and collect checks (supplemented later by an electronic funds transfer network). The Federal Reserve's most important job today, however, is to control money and credit conditions to promote economic stability. This final task assigned to the Fed is known as *monetary policy*, a topic we will examine later in this chapter.

The Banking Act of 1933 (Glass-Steagall)

Between 1929 and 1933, more than 9,000 banks failed and many Americans lost confidence in the banking system. The legislative response to this disappointing performance was to enact stricter rules and regulations in the **Glass-Steagall Act.** If as children we brought home failing grades, our parents might react by revoking our TV privileges and supervising our homework more closely. Congress reacted in much the same manner. The Glass-Steagall Act defined the boundaries of commercial banking by providing constraints that were effective for more than 60 years. This legislation separated commercial banking from investment banking and insurance. The "kids" (banks) could no longer play with their friends—providers of insurance and investment banking services.

The most important part of the Glass-Steagall Act was Section 16, which prohibited national banks from investing in stock and from underwriting new issues of *ineligible securities* (especially corporate stocks and bonds). Several major New York banking firms split into separate entities—for example, JP Morgan, a commercial banking firm, split off from Morgan Stanley, an investment bank. Congress feared that underwriting privately issued securities (as opposed to underwriting government-guaranteed securities, which has been legal for many years) would increase the risk of bank failure. Moreover, banks might be able to coerce their customers into buying the securities they were underwriting as a condition for getting a loan (called *tying arrangements*).

Factoid
What U.S. federal regulatory agency supervises and examines more banks than any other?
Answer: The Federal Deposit Insurance Corporation (FDIC).

Establishing the FDIC under the Glass-Steagall Act

One of the Glass-Steagall Act's most important legacies was quieting public fears over the soundness of the banking system. The **Federal Deposit Insurance Corporation** (FDIC) was created to guarantee the public's deposits up to a stipulated maximum amount (initially \$2,500; today up to \$250,000) in order to enhance public confidence in the banking system.

Without question, the FDIC, since its inception in 1934, has helped to reduce the number of bank "runs" where panicky depositors withdraw their money in large numbers, though it has not prevented bank failures. In fact, it may have contributed to individual bank risk taking and failure in some instances. Each insured depository institution is required to pay the federal insurance system an insurance premium based upon its volume of insurance-eligible deposits and its risk exposure. The hope was that, over time, the FDIC's pool of insurance funds would grow large enough to handle a considerable number of failures. However, the federal insurance plan was never designed to handle a rash of failures like those that occurred in the United States during the 1980s and again early in this century. This is why the FDIC was forced to petition Congress for additional borrowing authority when the U.S. insurance fund proved to be close to insolvency.

Key URL
Find information about how the FDIC regulates and examines banks at **www.fdic.gov/regulations/index.html**.

Criticisms of the FDIC and Responses via New Legislation: The FDIC Improvement Act (1991)

The FDIC became the object of strong criticism during the 1980s and 1990s. Faced with predictions from the U.S. General Accounting Office that failing-bank claims could render the deposit insurance fund broke, the House and Senate passed the **Federal Deposit Insurance Corporation Improvement Act** in 1991. This legislation permitted the FDIC to borrow from the Treasury to remain solvent, called for risk-based insurance premiums, and defined the actions to be taken when depository institutions fall short of meeting their capital requirements.

The debate leading to passage of the FDIC Improvement Act did not criticize the fundamental concept of deposit insurance, but it *did* criticize the way the insurance system had been administered through most of its history. Prior to 1993, the FDIC levied fixed insurance premiums on all deposits eligible for insurance coverage, regardless of the riskiness of an individual depository institution's balance sheet. This fixed-fee system led to a *moral hazard* problem: *it encouraged depository institutions to accept greater risk because the government was pledged to pay off their depositors if they failed.* More risky institutions were

Key URLs
If you are interested in finding a job as a bank examiner or another position with a bank regulatory agency see, for example, **www.fdic.gov/about/jobs**, **www.federalreserve.gov/careers**, and **www.occ.treas.gov/jobs/careers.htm**.

being supported by more conservative ones. The moral hazard problem also created the need for regulation because it encouraged some institutions to take on greater risk than they otherwise would have.

Most depositors (except for the very largest) do not carefully monitor bank risk. Instead, they rely on the FDIC for protection. Because this results in subsidizing the riskiest depository institutions, a definite need developed for a risk-scaled insurance system in which the riskiest banks paid the highest insurance premiums. Finally, in 1993, the FDIC implemented new deposit insurance premiums differentiated on the basis of risk. Nevertheless, the federal government today sells relatively cheap deposit insurance that may still encourage greater risk taking.

Congress also ordered the regulatory agencies to develop a new measurement scale for describing how well capitalized each depository institution is and to take "prompt corrective action" when an institution's capital begins to weaken, using such steps as slowing its growth, requiring the owners to raise additional capital, or replacing management. If steps such as these do not solve the problem, the government can seize a deeply troubled depository institution and sell it to a healthy institution. For example, in 2008 the FDIC strongly encouraged the acquisition of Wachovia Bank by Wells Fargo Bank using these powers.

Under the law, regulators have to examine all depository institutions over \$100 million in assets on site at least once a year; for smaller banks, on-site examinations have to take place at least every 18 months. Federal agencies were required to develop new guidelines for the depository institutions they regulate regarding loan documentation, internal management controls, risk exposure, and salaries paid to employees. At the same time, in reaction to the failure of the huge Bank of Credit and Commerce International (BCCI) of Luxembourg, which allegedly laundered drug money and illegally tried to secure control of U.S. banks, Congress ordered foreign banks to seek approval from the Federal Reserve Board before opening or closing any U.S. offices. They must apply for FDIC insurance coverage if they wish to accept small domestic deposits. Moreover, foreign bank offices can be closed if their home countries do not adequately supervise their activities, and the FDIC is restricted from fully reimbursing uninsured and foreign depositors if their banks fail.

In an interesting final twist the Federal Reserve was restrained from propping up failing banks with long-term loans unless the Fed, the FDIC, and the current presidential administration agreed that all the depositors of a bank should be protected in order to avoid damage to public confidence in the financial system. During the 2007–2009 global financial crisis, several banks, such as Bank of America and JP Morgan Chase, were propped up with government loans. Many members of Congress objected to this "too big to fail" (TBTF) approach and Congress voted to bring the force of "market discipline" to bear on depository institutions that have taken on too much risk and encourage most problem institutions to solve their own problems without government help.

In its earlier history, the FDIC's principal task was to restore public confidence in the banking system and avoid panic on the part of the public. Today, the challenge is how to *price* deposit insurance fairly so that risk is managed and the government is not forced to use excessive amounts of taxpayer funds to support private risk taking by depository institutions.[1]

[1]The FDIC is unique in one interesting aspect: While many nations collect funds from healthy institutions to pay off the depositors of failed depository institutions only when failure occurs, the FDIC steadily collects funds over time and invests them in interest-bearing government securities to build up a reserve until these funds are needed to cover failures.

Some observers believe that the FDIC *may* need a larger reserve in the future due to ongoing consolidation in the banking industry. Instead of facing mainly small institutional failures, as in the past, the FDIC may face record losses in the future from the failure of one or more very large depository institutions as happened during the credit crisis of 2007–2009, for example.

Raising the FDIC Insurance Limit?

As the 21st century opened, the FDIC found itself embroiled in another public debate: *Should the federal deposit insurance limit be raised?* The FDIC pointed out that the limit of protection for most depositors was set way back in 1980 at $100,000. In the interim, inflation in the cost of living had significantly reduced the real purchasing power of the FDIC's insurance coverage limit. Accordingly, the FDIC and several other groups recommended a significant coverage hike, along with an indexing of deposit insurance coverage to protect against inflation.[2]

Key Video Link
@ **http://www.fdic.gov/deposit/deposits/video/videos.html** view a series of 10 videos that explain insurance coverage for different types of accounts.

Proponents of the insurance hike pointed out that depository institutions had lost huge amounts of deposits to mutual funds, security brokers and dealers, retirement plans provided by insurance companies, and the like. Thus, it was argued, depository institutions needed a boost to make their deposits more attractive in the race for the public's savings.

Opponents of an insurance increase also made several arguments. For example, the original purpose of the insurance program was to protect the smallest, most vulnerable depositors, and $100,000 seemed to fulfill that purpose nicely (even with inflation taken into account). Moreover, the more deposits that are protected, the more likely it is that depository institutions will take advantage of a higher insurance limit and make high-risk loans that, if they pay off, reap substantial benefits for both stockholders and management (behavior we referred to earlier as *moral hazard*). On the other hand, if the risky loans are not repaid, the depository institution involved fails, but the government is there to rescue its depositors. With more risk taking, more depository institutions will probably fail, leaving a government insurance agency (and, ultimately, the taxpayers) to pick up the pieces and pay off the depositors.

Factoid
Which U.S. banking agencies use taxpayers' money to fund their operations?
Answer: None of them do; they collect fees from the banks supervised, and some, like the Federal Reserve, have earnings from their trading in securities and the making of loans.

Finally, Congress resolved many of the deposit insurance issues when it passed the Dodd-Frank Regulatory Reform Act of 2010 (FINREG). The insurance limit was pushed, at least temporarily, to $250,000 for all categories of deposits. National banks and nonbank depository institutions (thrifts) were brought under the same federal regulator, the Office of the Comptroller of the Currency (OCC), part of the U.S. Treasury Department.

Instilling Social Graces and Morals—Social Responsibility Laws

The 1960s and 1970s ushered in a concern with the impact banks and other depository institutions were having on the quality of life in the communities they served. Congress feared that these institutions were not adequately informing their customers of the terms under which loans were made and especially about the true cost of borrowing money. In 1968 Congress moved to improve the flow of information to the consumer of financial services by passing the Consumer Credit Protection Act (known as Truth in Lending), which required that lenders spell out the customer's rights and responsibilities under a loan agreement. Subsequent legislation over the years, most recently the Dodd-Frank Regulatory Reform bill, has emphasized providing consumers with more complete and understandable language to convey service prices and avoid misleading information.

Key URL
The Federal Deposit Insurance Corporation has several of the finest banking sites on the Web, all of which can be directly or indirectly accessed through **www.fdic.gov**.

In 1974, Congress targeted potential discrimination in providing financial services to the public with passage of the Equal Credit Opportunity Act. Individuals and families could not be denied a loan merely because of their age, sex, race, national origin, or religious affiliation, or because they were recipients of public welfare. In 1977, Congress passed the Community Reinvestment Act (CRA), prohibiting U.S. banks from

[2]During the 2007–2009 credit crisis at least two European nations, Ireland and Greece, moved to fully insure the debt of their top financial institutions, while government agencies elsewhere in Asia and Europe (such as the United Kingdom, France, and Germany) flooded their troubled financial firms with cash (liquidity) and boosted their capital.

Insights and Issues

HOW THE FDIC USUALLY RESOLVES THE FAILURE OF AN INSURED DEPOSITORY INSTITUTION

Most troubled situations are detected in a regular examination of a depository institution conducted by either federal or state agencies. If examiners find a serious problem, they ask management and the board of directors of the troubled institution to prepare a report, and a follow-up examination normally is scheduled several weeks or months later. If failure seems likely, FDIC examiners are called in to see if they concur that the troubled institution is about to fail.

The FDIC then must choose among several different methods to resolve each failure. The two most widely used methods are *deposit payoff* and *purchase and assumption.* A deposit payoff is used when the closed institution's offices are not to be reopened, often because there are no interested bidders and the FDIC perceives that the public has other convenient banking alternatives. With a payoff, all insured depositors receive checks from the FDIC for up to $250,000 per depositor, while uninsured depositors and other creditors receive a pro rata share of any funds generated from the eventual liquidation of the troubled institution's assets. A purchase and assumption transaction, on the other hand, is employed if a healthy institution can be found to take over selected assets and the deposits of the failed institution.

When a purchase and assumption is employed, shortly before the bank is scheduled to close, the FDIC will contact healthy depository institutions in an effort to solicit bids for the failing institution. Interested buyers will negotiate with FDIC officials on the value of the failing institution's "good" and "bad" assets and on which assets and debts the FDIC will retain for collection and which will become the responsibility of the buyer.

On a predetermined date the state or federal agency that issued the troubled institution's charter officially closes the troubled firm and its directors and officers meet with FDIC officials. After that meeting a press release is issued and local newspapers are contacted.

On the designated closing date the FDIC's liquidation team assembles at some agreed-upon location. When all team members are ready (and often just after the troubled firm's offices are closed for the day), the liquidation team will enter the failed depository and place signs on the doors indicating it has been seized by the FDIC. The team will move swiftly to take inventory of all assets and determine what funds depositors and other creditors are owed. In subsequent days the liquidators may move their operations to rented office space nearby so the closed institution's facilities can open for business under the control of its new owners. Increasingly, in Europe and Asia, nations are cooperating in closing troubled banks, especially in the wake of the recent credit crisis.

Key Video Link
@ http://www.law.harvard.edu/news/spotlight/public-service/warren-consumer-financial-protection-bureau.html hear Harvard Professor Elizabeth Warren explain the purpose of the Bureau of Consumer Financial Protection.

discriminating against customers residing within their trade territories merely on the basis of the neighborhood in which they lived. Government examiners must periodically evaluate each bank's performance in providing services to all segments of its trade area and assign an appropriate CRA numerical rating.

Further steps toward requiring fair and equitable treatment of customers and improving the flow of information from banks to consumers were taken in 1987 with passage of the Competitive Equality in Banking Act and in 1991 with approval of the Truth in Savings Act. These federal laws required banks to more fully disclose their service policies and the true rates of return offered on the public's savings and the fees associated with credit services. Today consumer information is increasingly provided by the Bureau of Consumer Financial Protection (BCFP), an independent service unit housed within the Federal Reserve System.

Concept Check

2–3. What is the principal role of the Comptroller of the Currency?

2–4. What is the principal job performed by the FDIC?

2–5. What key roles does the Federal Reserve System perform in the banking and financial system?

2–6. What is the Glass-Steagall Act, and why was it important in banking history?

2–7. Why did the federal insurance system run into serious problems in the 1980s and 1990s? Can the current federal insurance system be improved? In what ways?

2–8. How did the Equal Credit Opportunity Act and the Community Reinvestment Act address discrimination?

Legislation Aimed at Allowing Interstate Banking: Where Can the "Kids" Play?

Not until the 1990s was one of the most controversial subjects in the history of American banking—*interstate bank expansion*—finally resolved. Prior to the 1990s many states prohibited banking firms from entering their territory and setting up full-service branch offices. Banks interested in building an interstate banking network usually had to form holding companies and acquire banks in other states as *affiliates* of those holding companies—not the most efficient way to get the job done because it led to costly duplication of capital and management. Moreover, many states as well as the federal government for a time outlawed an out-of-state holding company from acquiring control of a bank unless state law specifically granted that privilege.

The Riegle-Neal Interstate Banking Law (1994)

In an effort to reduce the cost of duplicating companies and personnel in order to cross state lines and provide more convenient services to millions of Americans, Congress voted in August 1994 to approve a new interstate banking law. The **Riegle-Neal Interstate Banking and Branching Efficiency Act** was signed into law by President Bill Clinton, repealing provisions of the McFadden Act of 1927 and the Douglas amendment of 1970 that prevented full-service interstate banking nationwide. Major provisions of the Riegle-Neal Act included:

- Adequately capitalized and managed holding companies can acquire banks anywhere in the United States.
- Interstate holding companies may consolidate their affiliated banks acquired across state lines into full-service branch offices. However, branch offices established across state lines to take deposits from the public must also create an adequate volume of loans to support their local communities.[3]
- No single banking company can control more than 10 percent of nationwide deposits or more than 30 percent of deposits in a single state (unless a state waives this latter restriction).

Factoid
One reason interstate banking laws were passed during the 1990s is that more than 60 million Americans were then crossing state lines daily on their way to work, school, or shopping. Moreover, there was a need to permit mergers across state lines to absorb failing depository institutions.

Thus, for the first time in U.S. history, banking laws granted a wide spectrum of American banks the power to accept deposits and follow their customers across state lines, perhaps eventually offering full-service banking nationwide. While the change undoubtedly enhanced banking convenience for some customers, some industry analysts feared these new laws would increase consolidation of the industry in the largest banks and threaten the survival of smaller banks. We will return to many of these issues in Chapter 3.

[3]Concern that interstate banking firms may enter a particular state and drain away its deposits led the U.S. Congress to insert Section 109 in the Riegle-Neal Interstate Banking Act, which prohibits a bank from establishing or acquiring branch offices outside its home state *primarily for deposit production.* The same prohibition applies to interstate acquisitions of banks by holding companies. Interstate acquirers are expected to make an adequate volume of loans available in those communities outside their home state that they have entered with deposit-taking facilities.

Several steps are taken annually to determine if an interstate banking firm is in compliance with Section 109. First, an interstate bank's statewide loan-to-deposit ratio is computed for each state it has entered and that ratio is compared to the entered state's overall loan-to-deposit ratio for all banks based in that state. Regulatory agencies look to see if the interstate bank's loan-to-deposit ratio in a given state is *less than half* of that state's overall loan-to-deposit ratio for banks calling that state home. If it is, an investigation ensues to determine if the banking firm's interstate branches are "reasonably helping to meet the credit needs of the communities served." A banking firm failing this investigation is subject to penalties imposed by its principal federal regulator.

Bank Expansion Abroad

While U.S. banks still face a few restrictions on their branching activity, even in the wake of the Riegle-Neal Interstate Banking Act, banks in most other industrialized countries usually do not face regulatory barriers to creating new branch offices. However, some nations, including Canada and member states of the European Community (EC), either limit foreign banks' branching into their territory (in the case of Canada) or reserve the right to treat foreign banks differently if they so choose. Within the European Community, EC-based banks may offer any services throughout the EC that are permitted by each bank's home country.

Moreover, each European home nation must regulate and supervise its own financial-service firms, no matter in what markets they operate inside the EC's boundaries, a principle of regulation known as *mutual recognition*. For example, banks chartered by an EC member nation receive, in effect, a single banking license to operate wherever they wish inside the European Community. However, because EC countries differ slightly in the activities in which each country allows its financial firms to engage, some regulatory arbitrage may exist in which financial-service firms migrate to those areas around the globe that permit the greatest span of activities and impose the fewest restrictions against geographic expansion.

The Gramm-Leach-Bliley Act (1999): What Are Acceptable Activities for Playtime?

One of the most important U.S. banking statutes was signed into law by President Bill Clinton in November 1999. Overturning long-standing provisions of the Glass-Steagall Act and the Bank Holding Company Act, the Financial Services Modernization Act (more commonly known as the **Gramm-Leach-Bliley Act** or GLB) permitted well-managed and well-capitalized banking companies with satisfactory Community Reinvestment Act (CRA) ratings to affiliate with insurance and securities firms under common ownership. Conversely, securities and insurance companies could form financial holding companies (FHCs) that control one or more banks. Banks were permitted to sell insurance and security services provided they conform to state and federal rules.

GLB permitted banking-insurance-securities affiliations to take place either through (1) a financial holding company (FHC), with banks, insurance companies or agencies, and securities firms each operating as separate companies but controlled by the same stock-holding corporation (if approved by the Federal Reserve Board) or (2) subsidiary firms owned by a bank (if approved by the bank's principal regulator).

GLB's purpose was to allow qualified U.S. financial-service companies the ability to diversify their service offerings and thereby reduce their overall business risk exposure. For example, if the banking industry happened to be in a recession with declining profits, the insurance or securities industry might be experiencing an economic boom with rising profits, thereby bringing greater overall stability to a fully diversified financial firm's cash flow and profitability.

GLB offered many financial-service customers the prospect of "one-stop shopping," obtaining many, if not all, of their financial services from a single provider. While this type of *convergence* of different financial services may well increase customer convenience, some financial experts believe that competition may be reduced as well if larger financial-service providers continue to acquire smaller financial firms and merge them out of existence. In the long run the public may have fewer alternatives and could wind up paying higher fees.

One of the most controversial parts of GLB concerned *customer privacy*. It requires financial-service providers to disclose their policies regarding the sharing of their customers' private ("nonpublic") data with others. When customers open a new account, they must be told what the financial-service provider's customer privacy policies are and be informed at least once a year thereafter about the company's customer privacy rules.

The Gramm-Leach-Bliley Act of 1999

(MODIFICATION AND REPEAL OF THE GLASS-STEAGALL ACT OF 1933)

- Commercial banks can affiliate with insurance companies and securities firms (either through the holding-company route or through a bank subsidiary structure), provided they are well capitalized and have approval from their principal federal supervisory agency.
- Protections must be put in place for consumers considering the purchase of insurance through a bank. Consumers must be reminded that nondeposit financial-service products, including insurance, mutual funds, and various other products, are *not* FDIC-insured and their purchase cannot be imposed by a lender as a requirement for obtaining a loan.
- Banks, insurance companies, security brokers, and other financial institutions must inform consumers about their *privacy policies* when accounts are opened and at least once a year thereafter, indicating whether consumers' personal information can be shared with an affiliated firm or with outsiders. Customers are allowed to "opt out" of their financial institutions' plans for sharing customer information with unaffiliated parties.
- Fees to use an automated teller machine (ATM) must be clearly disclosed at the site where the machine is located so that customers can choose to cancel a transaction before they incur a fee.
- It is a federal crime, punishable with up to five years in prison, to use fraud or deception to steal someone else's "means of identification" (*identify theft*) from a financial institution.

GLB allowed affiliates of the same financial-services company to share personal customer information with each other. Customers cannot prevent this type of *internal* sharing of their personal information, but they are permitted to "opt out" of any private information sharing by financial-service providers with third parties, such as telemarketers. GLB states that customers must notify their financial-service firms if they do not want their personal information shared with "outsiders."

Although many customers appear to be concerned about protecting their privacy, many financial firms are fighting recent attempts that limit information sharing about customers. These companies point out that by sharing personal data, the financial firm can more efficiently design and market services that will benefit its customers.

Moreover, some financial firms argue they can make better decisions and more effectively control risk if they can share customer data with others. For example, if an insurer knows that a customer is in poor health or is a careless driver and would not be a good credit risk, this information would be especially helpful to a lender who is part of the same company in deciding whether this customer should be granted a loan.

Factoid
What is the fastest growing financial crime in the United States? **Answer:** *Identity theft*—the act of stealing and fraudulently using an individual's personal (nonpublic) information—a subject addressed with stiffer criminal penalties by the Identify Theft and Assumption Deterrence Act of 1998.

Key Video Link
@ http://video.answers.com/the-patriot-act-in-the-us-297290926 watch Nadine Strossen, a law professor at New York Law School, discuss provisions of the USA Patriot Act.

The USA Patriot and Bank Secrecy Acts: Fighting Terrorism and Money Laundering

Adverse political developments and news reports rocked the financial world as the 21st century began and gave rise to more financial-services regulation. Terrorists used commercial airliners to attack the World Trade Center in New York City and the Pentagon in Washington, D.C., with great loss of life on September 11, 2001. The U.S. Congress responded with passage of the **USA Patriot Act** in the Fall of that same year. The Patriot Act made a series of amendments to the Bank Secrecy Act (passed originally in 1970 to combat money laundering) that required selected financial institutions to report "suspicious" activity on the part of their customers.

Among the numerous provisions of the Patriot and amended Bank Secrecy Acts are requirements that financial-service providers establish the *identity* of customers opening new accounts or holding accounts whose terms are changed. This is usually accomplished by asking for a driver's license or other acceptable picture ID and obtaining the Social Security number of the customer. Service providers are required to check the

ETHICS IN BANKING AND FINANCIAL SERVICES

BANK SECRECY AND REPORTING SUSPICIOUS TRANSACTIONS

Recent anti–money laundering and antiterrorist legislation, especially the Bank Secrecy and USA Patriot Acts, have attempted to turn many financial-service institutions, particularly banks, security brokers, and investment advisers, into "front-line cops" in the battle to ferret out illegal or suspicious financial activities. For example, in the United States if a covered financial firm detects suspicious customer activity it must file a SAR (suspicious activity report) with the Financial Crimes Enforcement Network, inside the U.S. Treasury Department. Moreover, every federally supervised financial firm must develop and deploy a Customer Identification Plan (CIP) that gives rise to screening computer software and office procedures to make sure each institution knows who its customers are and can spot suspicious financial activity that may facilitate terrorism.

Some bankers have expressed concern about these suspicious-activity reporting requirements. One problem is the high cost of installing computer software and launching employee training programs and the substantial expense of hiring more accountants and lawyers to detect questionable customer account activity. Another problem centers on the vagueness of the new rules—for example, what exactly is "suspicious activity"? Bankers are usually trained to be bankers, not policemen. Because of uncertainty about what to look for and the threat of heavy fines many financial firms tend to "overreport"—turning in huge amounts of routine customer data to avoid being accused of "slacking" in their surveillance activities. (The Bank Secrecy Act requires any cash transaction of $10,000 or more to be reported to the government.) Other bankers are simply uncomfortable about eavesdropping on their customers' business and possibly setting in motion a "witch hunt."

For their part, regulators argue that these requirements are essential in the modern world where an act of terrorism seems to happen somewhere nearly every day. If bankers and other financial advisers have not been educated in the past to spot suspicious financial transactions, then, it is argued, they must become educated. Regulators contend that poor reporting and lax law enforcement threaten the safety of the public and the institutions that serve them.

Recently public debate over governments' secret surveillance of private citizens, especially listening to their phone calls and reading their e-mails, has become particularly intense. Those opposed to secret snooping by government agents have argued that the government should be required to seek warrants in court before monitoring private conversations. Otherwise, lawsuits might be brought on grounds that privacy and wiretapping laws are being violated. On the other hand, proponents of government eavesdropping contend that secret wiretaps are necessary to keep people safe in a post-9/11 world.

customer's ID against a government-supplied list of terrorist organizations and report any suspicious activity in a customer's account.

Key Video Link
@ **http://videos.howstuffworks.com/multivu/1848-western-union-video.htm** see how Western Union works.

Recent evidence suggests that governments intend to enforce laws like the Patriot and Bank Secrecy Acts. For example, in the Fall of 2002 Western Union was fined $8 million for allegedly failing to fully comply with the requirements for reporting money transfers. In Great Britain, which has a similar law, The Royal Bank of Scotland, second largest in the British Isles, was fined the equivalent of about $1.2 million for allegedly not taking enough care to establish its customers' identities. More recently, Riggs National Bank in Washington, D.C. (now owned by PNC Financial Services), Banco Popular de Puerto Rico, and Arab Bank PLC were fined for not filing adequate reports of possible money-laundering activities by some of their international customers.

Key URLs
For further information about the USA Patriot, Bank Secrecy, and Sarbanes-Oxley Acts see **www.fdic.gov**, **www.sec.gov**, **www.AICPA.org**, and **www.soxlaw.com**.

Telling the Truth and Not Stretching It—The Sarbanes-Oxley Accounting Standards Act (2002)

On the heels of the terrorist attacks of 9/11 came disclosures in the financial press of widespread manipulation of corporate financial reports and questionable dealings among leading corporations (such as Enron), commercial and investment bankers, and public accounting firms to the detriment of employees and market investors. Faced with deteriorating public confidence the U.S. Congress moved quickly to pass the **Sarbanes-Oxley Accounting Standards Act** of 2002.

Sarbanes-Oxley created the Public Company Accounting Oversight Board to enforce higher standards in the accounting profession and to promote accurate and objective audits of the financial reports of public companies (including financial-service corporations). Publishing false or misleading information about the financial performance and condition of publicly owned corporations is prohibited. Moreover, top corporate officers must vouch for the accuracy of their companies' financial statements. Loans to senior management and directors (insiders) of a publicly owned lending institution are restricted to the same credit terms that regular customers of comparable risk receive. Sarbanes-Oxley demanded tougher internal controls, promoted the power and independence of corporate boards, and led to hundreds of companies restating their financial results for greater accuracy. Beginning in 2003, federal banking agencies acquired the power to bar accounting firms from auditing depository institutions if these firms displayed evidence of negligence, reckless behavior, or lack of professional qualifications.

2–4 The 21st Century Ushers in an Array of New Laws and Regulations—FINREG, The Basel Agreement, and Other Rules Around the Globe

The opening decade of the 21st century unfolded with a diverse set of new laws and new regulations to enforce them, in some cases creating opportunities for financial firms to reduce their operating costs, expand their revenues, and better serve their customers.

Key URL
To determine how U.S. citizens can request and receive a free credit report see, for example, **www.annualcreditreport.com/cra.index.jsp**.

The FACT Act

In 2003 the Fair and Accurate Credit Transactions (FACT) Act was passed in an effort to head off the growing problem of *identity* (ID) *theft,* in which thieves attempt to steal a person's identifying private information (such as a Social Security number) in an effort to gain access to the victim's bank account, credit cards, or other personal property. The U.S. Congress ordered the Federal Trade Commission to make it easier for individuals victimized by ID theft to file a theft report and required the nation's credit bureaus to help victims resolve the problem. Individuals and families are entitled to receive at least one free credit report each year from each of the three national credit bureaus (Experian, EquiFax, and Transunion) to determine if they have been victimized by this form of fraud. Many financial institutions see the new law as helping to reduce their costs, including reimbursements to customers, due to ID theft.

Check 21

Key Video Link
@ **http://videos.howstuffworks.com/business-and-money/credit-card-videos-playlist.htm#video-459** learn about identity theft and why individuals are victims of this crime.

The following year the Check 21 Act became effective, reducing the need for depositors/institutions to transport paper checks across the country—a costly and risky operation. Instead, Check 21 allows checking-account service providers to replace a paper check written by a customer with a "substitute check," containing images of the original check. Substitute checks can be transported electronically at a fraction of the cost of the old paper-check system. Thus, the Check 21 Act promotes the ongoing swing toward electronic payment systems and away from writing and processing more checks.

New Bankruptcy Rules

In 2005 banking industry lobbyists fought successfully for passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, tightening U.S. bankruptcy laws. The new laws will tend to push higher-income borrowers into more costly forms of bankruptcy. More bankrupts will be forced to repay at least some of what they owe. Bankers favoring the new laws argued that they would lower borrowing costs for the average customer and encourage individuals and businesses to be more cautious in their use of debt.

Federal Deposit Insurance Reform

With passage of the Federal Deposit Insurance Reform Act of 2005 the U.S. Congress expanded the safety net protecting the retirement savings of individual depositors, allowed federal regulators to periodically adjust deposit insurance coverage upward to fight inflation, and stabilized the flow of premium payments into a single insurance fund for all federally supervised bank and thrift institutions.[4]

Key URL
Financial stability became a national issue during the credit crisis of 2007–2009. An official government website provides information and data relating to EESA and TARP (**www.financialstability.gov**).

2008 "Bailout Bill" and Strengthing Bank Capital

Turmoil and loss in the home mortgage market and the financial system beginning in 2007 gave rise to a welter of proposed new regulations applying to mortgage lenders and brokers, credit-rating agencies, and other key financial firms. Among the most comprehensive new rules were those proposed by the President's Working Group on Financial Markets, some of which became law with passage of the Emergency Economic Stabilization Act passed in 2008 during the global credit crisis. This "bail-out" bill granted the U.S. Treasury the means to purchase up to $700 billion in "bad" assets (such as troubled mortgages and consumer loans), allowed the FDIC to temporarily increase deposit insurance protection up to $250,000 per account holder (later made permanent), and permitted the government to inject additional capital into banks and other qualified lenders in order to increase public confidence in credit-granting institutions and markets.

The 2009 CARD Act and Greater Disclosure of Information

In the midst of great public concern over the health of the economy and the lack of jobs during one of the most severe recessions in the past century the U.S. Congress took up long-standing issues surrounding the use of credit cards. In the past banks and other card issuers frequently avoided making full and timely disclosure of credit terms—interest rates, various service fees and penalties for overcharging and late payments, etc.—attached to their credit account plans. Many card companies looked for repeated opportunities to raise interest rates, add more fees, and delay timely recording of customer payments with minimal disclosure of information.

The 2009 Credit Card Accountability, Responsibility, and Disclosure Act (known as CARD) put restrictions on varying credit card interest rates and other terms, including giving at least 45 days advance notice in writing before card terms are changed. Fees must be spelled out and limited to single, rather than multiple, fees per billing cycle. Customers must be told how much interest they are paying and how long it will take to pay off an account if only the minimum payment is made on each due date. Card issuers must reveal their contract provisions on the Internet, providing sufficient disclosure so that customers can do comparison shopping.

Financial Reform With FINREG: The Swing Back from Deregulation to More Regulation

In the financial world regulation often blows hot and cold, sometimes marching in the door with a heavy burden of government oversight and sometimes only a light one. This pattern often resembles a pendulum of a clock in constant motion, swinging from one side to the other, depending on what problems have recently emerged and public attitudes.

[4]See Chapters 12 and 18 for additional discussion of the Check 21, FACT, and FDIC Insurance Reform Acts and new bankruptcy rules.

Insights and Issues

FINANCIAL REFORM ON A GRAND SCALE: THE NEW FINREG LAW OF 2010

In the summer of 2010 President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, named after its congressional sponsors, Senator Christopher Dodd of Connecticut and Congressman Barney Frank of New York. Bearing the shorthand label, FINREG, the new law was the most sweeping federal financial legislation since the passage of the Banking Acts of 1933 and 1935 that were passed during the infamous Great Depression. It centered upon protecting against failure and controlling systemic risk in the financial sector, promoting greater transparency in the flow of information to consumers of financial services, improving regulation of key financial firms, and restoring public confidence in financial affairs.

Among the key provisions of FINREG are the following:

- Creating new procedures for dismantleing large, seriously troubled financial-service companies (bank and nonbank) similar to the process used by the FDIC for decades to dispose of failing banks.
- Emaciating the "too big to fail" doctrine so that even large financial institutions will henceforth be allowed to fail without the government, the central bank, or taxpayers bailing them out.
- Establishing a Financial Stability Oversight Council (FSOC), composed of leaders of financial regulatory agencies and chaired by the Secretary of the Treasury, to develop measures of systemic risk across the global financial system and to develop regulatory remedies to reduce the financial sector's system-wide risk exposure.
- Developing measures and rules for promoting the adequacy of bank capital and the strength of bank liquidity, so that depository institutions are better protected against various forms of risk.
- Increasing public confidence in the safety and security of bank and thrift deposits by boosting insurance coverage provided by the FDIC from a minimum of $100,000 to $250,000.
- Consolidating the federal regulatory agencies overseeing banks and thrifts by merging the Office of Thrift Supervision (OTS) into the Office of the Comptroller of the Currency (OCC) so that the FDIC, the OCC, and the Federal Reserve (Fed) more closely control the actions of depository institutions.
- Increasing transparency and oversight of trading activity for financial derivatives (such as credit default swaps and mortgage-backed securities) by the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) and through the use of public clearinghouses and public exchanges to trade and track these complex instruments.
- Creating closer regulation of various securities firms, principally by the SEC, including hedge funds, private equity funds, and investment advisers, in the interest of the public.
- Increasing scrutiny of the insurance industry through the new Office of Federal Insurance (OFI), including improved regulation and quality of supervision of an industry previously regulated only by the states.
- Establishing more oversight of credit-rating agencies (CRAs), through the new Office of Credit Ratings (OCR), reviewing the quality and accuracy of the credit-rating process, and making it easier for those damaged by raters' "reckless behavior" to file suit.
- Requiring closer evaluation of consumer lending activities, especially in providing credit to home buyers and for home improvement loans, in an effort to reduce loan foreclosures, to encourage greater home ownership, to support home rental counseling, and to educate the public regarding the essentials of home finance.
- Establishing a Bureau of Consumer Financial Protection (BCFP) within the structure of the Federal Reserve System, yet independent of the Fed, to promote fair lending and greater financial literacy on the part of the public.

For example, the Great Depression of the 1930s brought with it the failure of thousands of financial and nonfinancial firms and, consequently, thousands of new regulatory rules to deal with them. After World War II, and especially between the 1980s and 1990s, regulations were gradually loosened to make room for new products and new businesses, including complex financial institutions crossing state lines and ultimately reaching around the globe. The pendulum had swung again from regulation to deregulation until the 21st century came along when a serious economic recession struck and the pendulum in the financial marketplace switched from deregulation to reregulation, emblematic of the 1930s.

The result was a sweeping new federal law designed to rescue the global financial system from near-collapse—the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2009, named after its two main Congressional sponsors and known more familiarly to the press as FINREG.

The new law allowed federal regulatory agencies if necessary to downsize and unravel problem financial-service providers, prohibited regulators from applying “too big to fail” rules so that selected financial firms could be protected and rescued at public expense, created new federal agencies to protect consumers from abusive financial-service practices, worked to shelter the financial system from systemic risk that might “drown” the financial system, required financial firms to maintain adequate capital and liquidity, temporarily raised federal deposit insurance coverage, merged regulatory agencies for banks and thrifts into fewer agencies, expanded oversight of the financial derivatives marketplace, enlarged SEC rule-making and supervision over hedge funds and other security firms, began to examine more closely the activities of the insurance and credit rating industries to prevent “reckless behavior,” and improved the flow of information to consumers through a new financial protection agency that would encourage greater fairness and openness in consumer lending and promote financial literacy on the part of the public.

The new piece of legislation has proven to be highly controversial. Opposing groups quickly pointed to the complexity of the new law which covered well over 2,000 pages and displayed heavy dependence on regulators’ judgment rather than relying mainly upon the private marketplace. Moreover, Congress provided few explicit guidelines on preparing what will ultimately amount to hundreds of new rules. At the same time numerous research studies are called for and several new federal offices and departments were created, some without significant guidance on what these new creations are to do. Proponents of the new law, on the other hand, see it as the most significant modification of the financial sector since the Glass-Steagall Act of the 1930s and the best hope for dealing with systemwide risk in the global financial marketplace as we move into the future.

New Regulatory Strategies in the New Century

As we saw in the preceding section, the 1960s through the 1990s ushered in a period of extensive government *deregulation* of the financial sector with legal restrictions against geographic and service expansion drastically reduced, permitting regulated financial institutions to compete more effectively and respond more rapidly to changing market conditions.

For example, in 1980 the U.S. Congress passed the Depository Institutions Deregulation and Monetary Control Act (DIDMCA), which lifted U.S. government ceilings on deposit interest rates in favor of free-market interest rates. In 1982 the Garn–St Germain Depository Institutions Act made bank and nonbank depository institutions more alike in the services they could offer and allowed banks and thrift institutions to more fully compete with other financial institutions for the public’s money. Passage of the Financial Institutions Reform, Recovery and Enforcement Act in 1989 allowed bank holding companies to acquire nonbank depository institutions and, if desired, convert them into bank branch offices.

Using Capital as a Regulator With the opening of the new century, however, there emerged a changed emphasis in the field of government regulation of the financial sector. In particular, the regulation of *capital* and *risk taking* became more important. Increasingly, government regulatory agencies expressed concern about whether banks and their competitors held sufficient capital (especially funds contributed by their owners) to absorb large and unpredictable losses and protect the public. U.S. banks’ capital requirements came to be based on the terms of the FDIC Improvement Act of 1991 and the international capital agreements known as Basel I and II, and later Basel III, began in 1988 between the United States and 12 other leading nations in Europe and Asia, imposing the same capital rules on all major banks around the globe.[5]

[5] For a much more detailed discussion of the Basel Agreements I, II, and III see Chapter 15.

Market Data as a Regulatory Warning Device Moreover, regulators began to take a more serious look at *market data* as a barometer of the strengths and weaknesses of individual financial institutions. For example, if a bank experiences a decline in the value of its stock or a rise in the interest cost attached to its senior debt instruments this could be a signal that this institution has taken on greater risk and needs closer scrutiny from regulators.

The Role Played by Public Disclosure in Regulating Financial-Service Firms The new century has also brought greater regulatory interest in *public disclosure*. For example, can we find a way to safely provide greater information to the public about the prices and fees of financial services and about how well financial institutions are or are not protecting their customers' private information? Can we find a way to reveal the true financial condition and risk of regulated financial firms without creating misunderstanding and mindless panic by the public? The hope among regulators is that greater public disclosure will promote greater competition in the financial-services sector, reduce risk taking, and help customers make better decisions about purchasing and using financial services.

Unresolved Regulatory Issues Unfortunately, even with all of these strides toward a new focus in regulation many key regulatory issues remain unresolved. For example:

- What should we do about the regulatory *safety net* set up to protect small depositors from loss, usually through government-sponsored deposit insurance? Doesn't this safety net encourage financial firms to take on added risk? How can we balance risk taking and depositor safety so that deposits in the banking system continue to grow, providing loans the public needs, especially in the wake of a credit crisis?
- How can we be sure that a conglomerate financial firm that includes a bank will not loot the bank in order to prop up its other businesses, causing the bank to fail and leaving it up to the government to pay off its depositors?
- As financial firms become bigger and more complex, how do we ensure that government regulators can effectively oversee what these more complicated firms are doing? Can we train regulators to be as good as they need to be in a more complex financial marketplace?
- Will *functional regulation*, in which each different type of business owned by a complex financial firm is regulated by a different and specialized government agency, really work? For example, an investment bank belonging to a conglomerate financial firm may be regulated by the Securities and Exchange Commission, while the commercial bank that conglomerate also owns may be regulated by the Comptroller of the Currency. What if these regulators disagree? Can they cooperate effectively for the public benefit?
- With the financial-services industry consolidating and converging into fewer, but bigger, firms, can we get by with fewer regulators? Can we simplify the current regulatory structure and bring greater efficiency to the task?
- What about *mixing banking and commerce?* Should industrial firms be free to acquire or start financial firms, and vice versa? For example, should a bank be able to sell cars and trucks alongside deposits and credit cards? Would this result in unfair competition? Would it create too much risk of bank failure? Should regulators be allowed to oversee industrial firms that are affiliated with financial firms in order to protect the latter?
- As financial firms reach their arms around the globe, what nation or nations should regulate their activities? What happens when nations disagree about financial-services regulation? What if a particular nation is a weak and ineffective regulator? Who should take up the slack? Shouldn't countries cooperate in financial-services regulation just as they do in the defense of their homelands?

Insights and Issues

BANKING AND COMMERCE: ONE OF THE HOT REGULATORY ISSUES FOR THE 21ST CENTURY

Many observers of the financial-services marketplace believe that the key regulatory issue in banking in the 21st century centers on *banking versus commerce*—how far will banks and nonfinancial industrial firms be able to go in invading each other's territory? How much overlap in ownership can we allow between financial and nonfinancial businesses and still adequately protect the public's savings?

Currently several legal barriers exist between banks and nonfinancial businesses, preventing their combining with each other. These barriers include such laws as the Bank Holding Company Act and the National Bank Act, which define what banks can and cannot do. For those companies that do find clever ways to slip through these barriers, Section 23 of the Federal Reserve Act limits transactions between bank and nonbank firms owned by the same company in order to protect banks from being looted by their nonbank affiliates. For example, bank transactions with an affiliated business cannot exceed 10 percent of the bank's capital or a maximum of 20 percent of a bank's capital for *all* its nonbank affiliates combined.

Even with such tough rules, however, serious holes have been punched in the legal barriers that prevent banks from affiliating with commercial and industrial firms over the years. For example, prior to passage of the Bank Holding Company Act (as amended in 1970) companies controlling a single bank could purchase or start virtually any other kind of business. After passage of this sweeping law, however, banking was confined essentially to the financial services sector with a couple of exceptions.

One of these exceptions centered around thrift institutions (such as savings and loans) that could get into the commercial sector by having a company acquire a single thrift and then add other businesses. Passage of the Gramm-Leach-Bliley Act of 1999 closed this *unitary thrift device.*

As the 21st century opened, still another crack in the barriers separating banking and commerce remained in the form of *industrial loan companies.* These state-chartered deposit and loan businesses are often affiliated with industrial firms and may provide credit to help finance the purchase of their parent company's products. Industrial loan companies raise funds by selling noncheckable deposits, and they can apply for FDIC insurance. These firms, centered mostly in California and Utah, currently play a fairly modest role in the financial sector, however, holding about $140 billion in assets compared to more than $10 trillion in total commercial bank assets.

Most recently with passage of the Dodd-Frank Financial Reform Law of 2010 further restrictions separating banking from nonbank firms were enacted. These nonbank entities include hedge funds, private equity funds, and venture capital companies. The purpose of the new legislation is to separate Wall Street security trading operations from traditional banking services.

The banking-commerce issue remains a hot one as creative financial minds look for (and often find) clever ways to invade new turf despite existing barriers. For an excellent expanded discussion of this issue, see John R. Walter [15].

Concept Check

2–9. How does the FDIC deal with most failures?

2–10. What changes have occurred in U.S. banks' authority to cross state lines?

2–11. How have bank failures influenced recent legislation?

2–12. What changes in regulation did the Gramm-Leach-Bliley (Financial Services Modernization) Act bring about? Why?

2–13. What new regulatory issues remain to be resolved now that interstate banking is possible and security and insurance services are allowed to commingle with banking?

2–14. Why must we be concerned about *privacy* in the sharing and use of a financial-service customer's information? Can the financial system operate efficiently if sharing nonpublic information is forbidden? How far, in your opinion, should we go in regulating who gets access to private information?

2–15. Why were the Sarbanes-Oxley, Bank Secrecy, and USA Patriot Acts enacted in the United States? What impact are these laws and their supporting regulations likely to have on the financial-services sector?

2–16. Explain how the FACT, Check 21, 2005 Bankruptcy, Financial Services Regulatory Relief, and Federal Deposit Insurance Reform Acts are likely to affect the revenues and costs of financial firms and their services to customers.

2–17. How and why was the Dodd-Frank Regulatory Reform Act crafted to reduce systemic risk in the financial system, promote fair lending, protect consumers, and separate banks from key nonbank firms in an effort to restore public confidence?

Epic Moments in the History of Modern Banking Regulation

Key URLs
The Federal Deposit Insurance Corporation has a nice summary of key banking laws in American history. See especially **www.fdic.gov/regulations/laws/important** and **www.fdic.gov/bank/historical/brief**.

1863–64—The *National Bank Act* grants the U.S. government the right to begin chartering and supervising national banks to expand the nation's supply of money and credit and to compete with banks chartered by the states.

1913—The *Federal Reserve Act* is signed into law, setting up the Federal Reserve System to improve the payments mechanism, supervise banks, and regulate the supply of money and credit in the United States.

1933—The *Glass-Steagall (Banking) Act* creates the Federal Deposit Insurance Corporation (FDIC) and separates commercial and investment banking into different industries.

1934—The *Securities and Exchange Act* requires greater disclosure of information about securities sold to the public and creates the Securities and Exchange Commission (SEC) to prevent the use of deceptive information in the marketing of securities.

1935—The *Banking Act* expands the powers of the Board of Governors as the chief administrative body of the Federal Reserve System and establishes the Federal Open Market Committee as the Fed's principal monetary policy decision-making group.

1956—The *Bank Holding Company Act* requires corporations controlling two or more banks to register with the Federal Reserve Board and seek approval for any new business acquisitions.

1960—The *Bank Merger Act* requires federal approval for any mergers involving federally supervised banks and, in subsequent amendments, subjects bank mergers and acquisitions to the antitrust laws.

1970—The *Bank Holding Company Act* is amended to include one-bank companies that must register with the Federal Reserve Board. Permissible nonbank businesses that bank holding companies can acquire must be "closely related to banking," such as finance companies and thrift institutions.

1977—The *Community Reinvestment Act (CRA)* prevents banks from "redlining" certain neighborhoods, refusing to serve those areas.

1978—The *International Banking Act* imposes federal regulation on foreign banks operating in the United States and requires FDIC insurance coverage for foreign banks selling retail deposits inside the United States.

1980—Deposit interest-rate ceilings are lifted and reserve requirements are imposed on all depository institutions offering checkable or nonpersonal time deposits under the terms of the *Depository Institutions Deregulation and Monetary Control Act.* Interest-bearing checking accounts are legalized nationwide for households and nonprofit institutions.

1982—With passage of the *Garn–St Germain Depository Institutions Act,* depositories may offer deposits competitive with money market fund share accounts, while nonbank thrift institutions are given new service powers that allow them to compete more fully with commercial banks.

1987—The *Competitive Equality in Banking Act* is passed, allowing some bank and thrift mergers to take place across state lines and requiring public disclosure of checking account deposit policies. The Federal Reserve Board rules that bank holding companies can establish securities underwriting subsidiaries subject to limits on the revenues they generate.

1988—The *Basel Agreement* imposes common minimum capital requirements on banks in leading industrialized nations based on the riskiness of their assets.

1989—The *Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)* is enacted to resolve failures of hundreds of depository institutions, and it set up the Savings Association Insurance Fund (SAIF). FIRREA launches the Office of Thrift Supervision inside the U.S. Treasury Department to regulate nonbank depository institutions. U.S. taxpayers wound up paying more than $500 billion to rescue the FDIC and resolve scores of bank and thrift failures.

1991—The *FDIC Improvement Act* mandates fees for deposit insurance based on risk exposure, grants the FDIC authority to borrow, creates the *Truth in Savings Act* to require greater public disclosure of the terms associated with selling deposits, and spells out minimum capital requirements for all U.S. banking companies.

(Continued)

Epic Moments in the History of Modern Banking Regulation *(continued)*

1994—The *Riegle-Neal Interstate Banking and Branching Efficiency Act* permits interstate full-service banking through acquisitions, mergers, and branching across state lines.

1999—The *Gramm-Leach-Bliley Financial Services Modernization Act* allows banks to create securities and insurance subsidiaries, and financial holding companies (FHCs) can set up banking, insurance, security, and merchant banking affiliates and engage in other "complementary" activities. Financial-service providers must protect the privacy of their customers and limit sharing private information with other businesses.

2000—The *European Monetary Union* allows European and foreign banks greater freedom to cross national borders. A new central bank, the ECB, can reshape money and credit policies in Europe, and the European Community adopts a common currency, the *euro.*

2001—The *USA Patriot Act* requires financial-service firms to collect and share information about customer identities with government agencies and to report suspicious activity.

2002—The *Sarbanes-Oxley Accounting Standards Act* requires publicly owned companies to strengthen their auditing practices and prohibits the publishing of false or misleading information about the financial condition or operations of a publicly held firm.

2003—The *Fair and Accurate Credit Transactions (FACT) Act* makes it easier for victims of identity theft to file fraud alerts, and the public can apply for a free credit report annually.

2004—The *Check 21 Act* makes it faster and less costly for banks to electronically transfer check images ("substitute checks") rather than ship paper checks themselves.

2005—The *Bankruptcy Abuse Prevention and Consumer Protection Act* requires more troubled business and household borrowers to repay at least some of their debts.

2005—The *Federal Deposit Insurance Reform Act* extends deposit insurance coverage on qualified retirement accounts from $100,000 to $250,000, authorizes the FDIC to periodically increase deposit insurance coverage to keep up with inflation, and merges bank and thrift insurance funds into a single deposit insurance fund (DIF).

2006—The *Financial Services Regulatory Relief Act of 2006* loosens regulations on depository institutions, adds selected new service powers to these institutions, and grants the Federal Reserve authority to pay interest on depository institutions' legal reserves if deemed necessary.

2008—The *Emergency Economic Stabilization Act* ushered in an emergency sale of "bad assets" (principally home mortgages and consumer loans) to free up global credit markets and reduce chances of a prolonged recession, while temporarily increasing FDIC deposit insurance coverage from $100,000 to $250,000 for all deposits, and allowing the U.S. Treasury to add capital to banks to enhance lending.

2010—The *Dodd-Frank Regulatory Reform (FINREG) Act* is a sweeping bill calling for elimination of the "too big to fail" doctrine, allowing major financial firms to be closed without being bailed out using government or taxpayer support, creating a Financial Stability Oversight Council to dampen systemic risk, establishing a Consumer Financial Protection Bureau to promote informed financial decision-making , and providing substantially greater FDIC deposit insurance coverage for all qualified deposit accounts.

- Finally, in the wake of the worldwide credit crisis that began in 2007 how can we fashion appropriate and effective regulatory rules that adequately protect consumers of financial services from fraud and deception, ensure an adequate supply of credit that supports jobs and the economy, provide adequate liquidity so that the payments system, even in crisis, functions smoothly and efficiently, and make financial transactions more transparent so that both lenders and borrowers understand their purposes and risks?

A preliminary answer emerged with passage of the Dodd-Frank Regulatory Reform Act in 2010, but many questions still remain if we are to reduce instability in the financial system and learn how to protect the public.

All of the foregoing questions represent tough issues in public policy to which regulators must find answers in this new century of challenge and global expansion.

2–5 The Regulation of Nonbank Financial-Service Firms Competing with Banks

Key Video Link
@ **http://www.finance-411.com/inside-look-how-does-a-credit-union-differ-from-a-bank-bloomberg** watch a Bloomberg report exploring "How Does a Credit Union Differ from a Bank?"

Regulating the Thrift (Savings) Industry

While commercial banks rank at or near the top of the list in terms of government control over their businesses, several other financial intermediaries—most notably credit unions, savings associations and savings banks, and money market funds—are not far behind. These so-called *thrift* institutions together attract a large proportion of the public's savings through selling relatively small savings accounts and grant a rapidly growing portion of consumer (household) loans. As such, even though they are privately owned, the thrifts are deemed to be "vested with the public interest" and, therefore, often face close supervision and regulation.

Key URLs
To find out more about credit unions, see the World Council of Credit Unions at **www.woccu.org** and the Credit Union National Association at **www.cuna.org**. For more about the regulation of credit unions see the National Credit Union Administration at **www.ncua.gov**.

Credit Unions

These nonprofit associations of individuals accept savings and share draft (checkable) deposits from and make loans only to their members. Federal and state rules prescribe what is required to be a credit union member—you must share a "common bond" with other credit union members (such as working for the same employer). Credit union deposits may qualify for federal deposit insurance coverage up to $250,000 from the National Credit Union Share Insurance Fund. During the 1930s the Federal Credit Union Act provided for federal as well as state chartering of qualified credit unions. Federal credit unions are supervised and examined by the **National Credit Union Administration** (NCUA). Several aspects of credit union activity are closely supervised to protect their members, including the services they are permitted to offer and how they allocate funds. Risk connected with granting loans to members must be counterbalanced by sizable investments in government securities, insured bank CDs, and other short-term money market instruments. Recently several credit unions have taken advantage of more liberal rules and converted to stockholder-owned depository institutions to attract new capital and gain added flexibility in their loans and investments.

Key URL
To further explore the characteristics and services of savings and loan associations and savings banks and the rules they are governed by, see the Office of Thrift Supervision at **www.ots.treas.gov**.

Savings and Loans and Savings Banks ("Thrifts")

These depository institutions include state and federal savings and loans and savings banks, created to encourage family savings and the financing of new homes. Government deregulation of the industry during the 1980s led to a proliferation of new consumer services to mirror many of those offered by commercial banks. Moreover, savings associations, like commercial banks, face multiple regulators in an effort to protect the public's deposits. State-chartered associations are supervised and examined by state boards or commissions, whereas federally chartered savings associations fall under the jurisdiction of the **Office of Thrift Supervision**, inside the U.S. Treasury Department. Then the Dodd-Frank Regulatory Reform Act was passed in 2010, merging the Office of Thrift Supervision (OTS) with the Office of the Comptroller of the Currency (OCC) so that thrift institutions and national banks would have the same regulatory agency at the federal level.

For several decades thrifts' deposits were insured by a different government fund—the Savings Association Insurance Fund (SAIF)—from the banks who were protected by the Bank Insurance Fund (BIF). Both the bank insurance fund and the thrift insurance fund were administered by the FDIC, but with different insurance fee schedules that led to controversy. However, in 2005 these two deposit insurance funds were merged into a single entity—the Deposit Insurance Fund (DIF), covering both banks and thrifts evenly. Regular deposit insurance coverage for thrifts, just like banks, climbed to $100,000 per deposit holder during the 1980s and then climbed upward again in 2005 toward $250,000 (at least temporarily). These insurance adjustments helped to catch up with inflation, generate greater public confidence, and improved the competitiveness of deposits as an investment for the public.

Money Market Funds

Although many financial institutions regard government regulation as burdensome and costly, money market funds owe their existence to regulations limiting the rates of interest banks and thrifts could pay on deposits. Security brokers and dealers found a way to attract short-term savings away from depository institutions and invest in money market securities bearing higher interest rates. Investment assets must be dollar denominated and have remaining maturities of no more then 397 days and a dollar-weighted average maturity of no more then 90 days. In the wake of the recent credit crisis the U.S. Treasury made federal insurance available to money market funds in an effort to calm the public's concerns and keep money fund share prices fixed at $1 per share, under the oversight of the **Securities and Exchange Commission** (SEC).

Regulating Other Nonbank Financial Firms

Key URLs
For additional information about life and property casualty insurers and the regulations they face, see especially the American Council for Life Insurance (**www.acli.com**) and the Insurance Information Institute (**www.iii.org**).

Life and Property/Casualty Insurance Companies

These sellers of risk protection for persons and property are one of the few financial institutions regulated almost exclusively at the state level. **State insurance commissions** generally prescribe the types and content of insurance policies sold to the public, often set maximum premium rates the public must pay, license insurance agents, scrutinize insurer investments for the protection of policyholders, charter new insurance companies, and liquidate failing ones.

Recently the federal government has become somewhat more involved in insurance company regulation. For example, when these firms sell equity or debt securities to the public, they need approval from the Securities and Exchange Commission—a situation that is happening more frequently as many mutual insurers (which are owned by their policyholders) are converting to stockholder-owned companies. Similarly, when insurers form holding companies to acquire commercial and investment banks or other federally regulated financial businesses, they may come under the Federal Reserve's review.

Finally, under the terms of the Dodd-Frank Regulatory Reform Act a new federal insurance office (FIO) was set up to help reduce the **systemic risk** caused by innovative, but sometimes highly risky, activities of the largest insurers (such as AIG) and prevent disruptive insurance failures.

Finance Companies

These business and consumer lenders have been regulated at the state government level for many decades, and state commissions look especially closely at their treatment of individuals borrowing money. Although the depth of state regulation varies across the United States, most states focus upon the types and contents of loan agreements they offer the public, the interest rates they charge (with some states setting maximum loan rates), and the methods they use to repossess property or to recover funds from delinquent borrowers. Relatively light state regulation has led to a recent explosion in the number of small-loan companies (such as payday lenders, pawn shops, and check-cashing firms) that generally provide small amounts of cash for a short time and usually charge the highest consumer loan interest rates of any financial institution.

Passage of the Dodd-Frank Regulatory Reform Act in 2010 had a major impact on these small-loan businesses, restricting their future growth and causing many to close.

In several states the loan rates these small-loan entities could charge were dropped from perhaps 300 to 400 percent to perhaps 30 to 40 percent. The future of this industry appeared doubtful, illustrating the powerful impact government regulations can have upon the success or failure of financially oriented businesses.

Filmtoid
What 2001 romantic comedy begins with stockbroker Ryan Turner (played by Charlie Sheen) finding himself without a job and being investigated by the SEC for insider trading?
Answer: *Good Advice*.

Mutual Funds

These investment companies, which sell shares in a pool of income-generating assets (especially stocks and bonds), have faced close federal and state regulation since the Great Depression of the 1930s when many failed. The U.S. Securities and Exchange Commission (SEC) requires these businesses to register with that agency, submit periodic financial reports, and provide investors with a prospectus that reveals the financial condition, recent performance, and objectives of each fund. Recently the SEC has cooperated closely with the FDIC in warning the public of the absence of federal deposit insurance behind these funds.

Security Brokers and Dealers and Investment Banks

A combination of federal and state supervision applies to these traders in financial instruments who buy and sell securities, underwrite new security issues, and give financial advice to corporations and governments. Security dealers and investment banks have been challenging commercial banks for big corporate customers for decades, but deregulation under the Gramm-Leach-Bliley Act of 1999 has encouraged commercial banks to fight back and win a growing share of the market for security trading and underwriting. The chief federal regulator is the SEC, which requires these firms to submit periodic reports, limits the volume of debt they take on, and investigates insider trading practices. Recent corporate scandals have redirected the SEC to look more closely at the accuracy and objectivity of the research and investment advice these companies pass on to their clients.

Hedge Funds, Private Equity Funds, and Venture Capital Companies

Some of the most lightly regulated of all financial institutions are *hedge funds, private equity funds*, and *venture capital companies*—investment partnerships that invite monies to flow in from wealthier investors and often promise exceptional returns. These private pools of investor capital are often subject to few government restraints. Almost anyone can start one of these firms, although lack of insurance and strict operating rules frequently means that if one of these entities gets into trouble, it often may not be able to attract any new capital or retain the funds it already has. Though facing almost no regulations, the Securities and Exchange Commission in the United States now has broad oversight of the information these firms provide to the public when they choose to sell securities in the open market that are accessible to small investors. Regulation in this sector is virtually invisible, in part because it is relatively new and because it normally does not seek out many funds from small investors, who are usually thought to need extra protection. For safety reasons the **Dodd-Frank Financial Reform Law** of 2010 calls for greater separation between commercial banks and these riskier private investors.

Key URLs
Important information about mutual funds, hedge funds, private equity funds, venture capital companies, investment banks, and security brokers and dealers may be found at such key sites as the Investment Company Institute (**www.ici.org**) and the Securities and Exchange Commission (**www.sec.gov**).

Are Regulations Really Necessary in the Financial-Services Sector?

A great debate is raging today about whether the remaining regulations affecting financial-service institutions are really necessary. Perhaps, as a leading authority in this field, George Benston, suggests [1], "It is time we recognize that financial institutions are simply businesses with only a few special features that require regulation." He contends that depository institutions, for example, should be regulated no differently from any other corporation with no subsidies or other special privileges.

Why? Benston contends that the historical reasons for regulating the financial sector—taxation of monopolies in supplying money, prevention of centralized power, preservation of solvency to mitigate the adverse impact of financial firm failures on the economy, and the pursuit of social goals (such as ensuring an adequate supply of viable housing loans for families and preventing discrimination and unfair dealing)—are no longer relevant today. Moreover, regulations are *not* free: they impose real costs in the form of taxes on money users, production inefficiencies, and reduced competition.

In summary, the trend in recent years has been toward freeing financial-service firms from rigid boundaries of regulation. However, the global financial crisis that burst into flames in 2007 emphasizes the adverse impact of financial firms failures and the importance of functional credit markets for the health of the worldwide economy. The failure of financial institutions and markets during this most recent period will be cause for a thorough review of regulations and the continuation of the debate concerning the benefits of free competition versus the need for regulation.

2–6 The Central Banking System: Its Impact on the Decisions and Policies of Financial Institutions

As we have seen in this chapter, law and government regulation exert a powerful impact on the behavior, organization, and performance of financial-service firms. But one other government-created institution also significantly shapes the behavior and performance of financial firms through its money and credit policies. That institution is the *central bank*, including the central bank of the United States, the Federal Reserve System (the Fed). Like most central banks around the globe, the Fed has more impact on the day-to-day activities of financial-service providers, especially on their revenues and costs, than any other institution, public or private.

A central bank's primary job is **monetary policy,** which involves making sure the supply and cost of money and credit from the financial system contribute to the nation's economic goals. By controlling the growth of money and credit, the Fed and other central banks around the globe try to ensure that the economy grows at an adequate rate, unemployment is kept low, and inflation is held down. Unfortunately these goals of central banks are not always achieved, as the credit crisis of 2007 illustrated.

In the United States the Fed is relatively free to pursue these goals because it does not depend on the government for its funding. Instead, the Fed raises its own funds from sales of its services and from securities trading, and it passes along most of its earnings (after making additions to its capital and paying dividends to member banks holding Federal Reserve bank stock) to the U.S. Treasury.

The nations belonging to the new European Union also have a central bank, the **European Central Bank (ECB),** which is relatively free and independent of governmental control as it pursues its main goal of avoiding inflation. In contrast, the **Bank of Japan** (BOJ), the **People's Bank of China** (PBC), and central banks in other parts of Asia appear to be under close control of their governments, and several of these countries have experienced higher inflation rates, volatile currency prices, and other significant economic problems in recent years. Though the matter is still hotly disputed, recent research studies (e.g., Pollard [11] and Walsh [10]) suggest that more independent central banks have been able to come closer to their nation's desired level of economic performance (particularly better control of inflation).

Key URL
The central website for the Board of Governors of the Federal Reserve System is **www.federalreserve.gov**.

Organizational Structure of the Federal Reserve System

To carry out the objectives noted above, many central banks have evolved into complex quasi-governmental bureaucracies with many divisions and responsibilities. For example, the center of authority and decision making within the Federal Reserve System is the

Board of Governors in Washington, D.C. By law, this governing body must contain no more than seven persons, each selected by the president of the United States and confirmed by the Senate for terms not exceeding 14 years. The board chairman and vice chairman are appointed by the president from among current board members, each for four-year terms (though these appointments may be renewed).

Factoid
Recently the Board of Governors of the Federal Reserve System has frequently fallen short of its allowable maximum of seven members due to the inability of the political process to agree on new members and the heavy burden of Board member responsibilities.

The board regulates and supervises the activities of the 12 district Reserve banks and their branch offices. It sets reserve requirements on deposits held by depository institutions, approves all changes in the discount (loan) rates posted by the 12 Reserve banks, and takes the lead within the system in determining open market policy to affect interest rates and the growth of money and credit.

The Federal Reserve Board members make up a majority of the voting members of the **Federal Open Market Committee (FOMC).** The other voting members are 5 of the 12 Federal Reserve bank presidents, who each serve one year in filling the remaining five official voting seats on the FOMC (except for the president of the New York Federal Reserve Bank, who is a permanent voting member). While the FOMC's specific task is to set policies that guide the conduct of **open market operations (OMO)**—the buying and selling of securities by the Federal Reserve banks—this body actually looks at the whole range of Fed policies and actions to influence the economy and financial system.

Key URL
All 12 Federal Reserve banks have their own websites that can be accessed from **www.federalreserve.gov/otherfrb.htm**.

Key Video Link
@ **http://www.time.com/time/video/player/0,32068,57544286001_1948059,00.html** see Time Video on "How the Federal Reserve Works."

The Federal Reserve System is divided into 12 districts, with a **Federal Reserve Bank** chartered in each district to supervise and serve member banks. Among the key services the Federal Reserve banks offer to depository institutions in their districts are (1) issuing wire transfers of funds between depository institutions, (2) safe-keeping securities owned by depository institutions and their customers, (3) issuing new securities from the U.S. Treasury and selected other federal agencies, (4) making loans to qualified depository institutions through the "Discount Window" in each Federal Reserve bank, (5) dispensing supplies of currency and coin, (6) clearing and collecting checks and other cash items, and (7) providing information to keep financial-firm managers and the public informed about developments affecting the welfare of their institutions.

All banks chartered by the Comptroller of the Currency (national banks) and those few state banks willing to conform to the Fed's supervision and regulation are designated **member banks.** Member institutions must purchase stock (up to 6 percent of their paid-in capital and surplus) in the district Reserve bank and submit to comprehensive examinations by Fed staff. Few unique privileges stem from being a member bank of the Federal Reserve System, because Fed services are also available on the same terms to other depository institutions keeping reserve deposits at the Fed. Many bankers believe, however, that belonging to the system carries prestige and the aura of added safety, which helps member banks attract large deposits.

Key URLs
Compare the Federal Reserve System to other leading central banks around the globe, especially the European Central Bank at **www.ecb.int**, the Bank of Japan at **www.boj.or.jp/en/** and the People's Bank of China at **www.pbc.gov.cn/english/**.

The Central Bank's Principal Task: Making and Implementing Monetary Policy

A central bank's principal function is to conduct money and credit policy to promote sustainable growth in the economy and avoid severe inflation.[6] To pursue these important objectives, most central banks use a variety of tools to affect the *legal reserves of the banking system*, the *interest rates charged on loans* made in the financial system, and *relative currency values* in the global foreign exchange markets.

By definition, *legal reserves* consist of assets held by a depository institution that qualify in meeting the reserve requirements imposed on an individual depository institution by central banking authorities. In the United States legal reserves consist of cash that deposi-

[6]The principal economic measures that leading central banks focus on include a measure of price inflation (such as the consumer price index), the unemployment rate, and the gross domestic product (GDP).

Insights and Issues

THE EUROPEAN CENTRAL BANK (ECB) VERSUS THE FEDERAL RESERVE ("THE FED")

In January 1999, 11 member nations of the European Union launched a new monetary system based on a single currency, the euro, and surrendered leadership of their monetary policymaking to a single central bank, the ECB, established in June 1998. This powerful central bank is taking leadership to control inflationary forces, promote a sounder European economy, and help stabilize the euro's value in international markets.

The ECB is similar in structure to the Fed with a governing council (known as the Executive Board, composed of six members) and a policy-making council (similar to the Fed's Federal Open Market Committee). The ECB has a cooperative arrangement with each EC member nation's central bank (such as Germany's Bundesbank and the Bank of France), just as the Fed's Board of Governors works with the 12 Federal Reserve banks that make up the Federal Reserve System. The ECB is the centerpiece of the European System of Central Banks, which includes

- The national central bank (NCB) of each member nation, and
- The ECB, headquartered in Frankfurt, Germany.

The chief administrative body for the ECB is its Executive Board, consisting of a president, vice president, and four bank directors, appointed by the European Council, which consists of the heads of state of each member nation. The key policy-making group is the Governing Council, which includes all members of the ECB's Executive Board plus the leaders of the national central banks of each member nation, each leader appointed by his or her home nation. Unlike the Fed the ECB does not engage in the supervision of individual banks but turns that task over to member nations of the EU.

Also unlike the Fed, which has multiple policy goals—including price stability, low unemployment, and sustainable economic growth—the ECB has a much simpler policy menu. Its central goal is *price stability,* attempting to keep inflation under 2 percent per year. Moreover, it has a relatively free hand in pursuing this goal with minimal interference from member states of the European Community. The principal policy tools of the ECB to help achieve price stability are open market operations and reserve requirements.

Although it has a simpler policy focus than the Fed, the ECB has no easy task. It must pursue price stability across different countries (with more nations from both eastern and western Europe joining the organization recently), each having somewhat different economies, political systems, and social problems. The ECB is a "grand experiment" in policy cooperation. How well it will work in keeping the right balance of political and economic forces in Europe remains to be seen. The ECB has gained credibility recently with its increasingly forceful decision making and its willingness to coordinate its policy moves with the Federal Reserve, the Bank of England, and other central banks, as happened during the recent global credit crisis.

tory institutions keep in their vaults and the deposits these institutions hold in their legal reserve accounts at the district Federal Reserve banks.

Each of a central bank's policy tools also affects the level and rate of change of interest rates. A central bank drives interest rates higher when it wants to reduce lending and borrowing in the economy and slow down the pace of economic activity; on the other hand, it lowers interest rates when it wishes to stimulate business and consumer borrowing as happened during the 2007–2009 credit crisis when more than half a dozen leading central banks cooperated to lower interest rates and stimulate global borrowing and lending in a declining economy. Central banks also can influence the demand for their home nation's currency by varying the level of interest rates and by altering the pace of domestic economic activity.

Key Video Link
@ http://www.stlouisfed.org/education_resources/inplainenglishvideo.cfm watch a video that outlines the basic tasks of the Federal Reserve.

To influence the behavior of legal reserves, interest rates, and currency values, central banks usually employ one or more of three main tools: open market operations, the discount rate on loans to qualified financial institutions, and legal reserve requirements on various bank liabilities. For example, the Bank of England uses weekly open market operations in the form of purchases of short-term government and commercial bills, makes discount loans, and imposes reserve requirements. The Swiss National Bank conducts open market operations in the currency markets and targets the three-month Swiss franc LIBOR (London Interbank Offer Rate), while Germany's Bundesbank trades security repurchase agreements and sets its preferred interest rates on short-term loans. In contrast, the Bank of Canada uses both open market operations and daily transfers of government deposits between private banks and the central bank to influence credit conditions. The fundamental point is that while different central banks may use different tools, nearly all focus upon the reserves of the banking system, interest rates, and, to some extent, currency prices as key operating targets to help achieve each nation's most cherished economic goals.

The Open Market Policy Tool of Central Banking

Among many leading nations today *open market operations (OMO)*, using a variety of financial instruments, have become the principal tool of central bank monetary policy. For example, in the United States the Federal Reserve System, represented by the System Open Market Account (SOMA) Manager at the trading desk inside the Federal Reserve Bank of New York, buys and sells U.S. Treasury bills, bonds, and notes and selected federal agency securities. These transactions are conducted between the Fed's trading desk and selected *primary dealers* who meet the Fed's qualifications. OMO is considered to be the most important policy tool for many central banks because it can be used every day and, if a mistake is made or conditions change, its effects can be quickly reversed.

Key URL
For further information about the Federal Open Market Committee (FOMC) and open market operations (OMO), see **www.federalreserve.gov/fomc/**.

Central bank *sales* of securities tend to *decrease* the growth of deposits and loans within the financial system. When the Fed sells securities, the dealers purchasing those securities authorize the Fed to deduct the dollar amount of the purchase from the reserve accounts that dealers' banks hold at a district Federal Reserve bank. Banks and other depository institutions have less raw material for making loans and extending other types of credit. Interest rates tend to *rise*.

In contrast, central bank *purchases* of securities tend to *increase* the growth of deposits and loans. The Federal Reserve pays for its purchases of securities simply by crediting the reserve deposits of the dealers' banks held at the Federal Reserve banks. This means that banks and dealers involved in the transaction have the proceeds of the securities' sale immediately available for their use. Interest rates tend to *fall*. (See Exhibit 2–1 for a list of several leading security dealers who are authorized to trade securities with the Federal Reserve.)

Key URL
To find out what it takes to become a primary dealer and trade with the Federal Reserve, see especially the Federal Reserve Bank of New York at **www.newyorkfed.org/aboutthefed/fedpoint/fed02.html**.

Today the Federal Reserve's Federal Open Market Committee (FOMC) targets the *federal funds rate* attached to overnight loans of reserves between depository institutions in order to achieve the Fed's monetary policy goals. Open market operations are carried out to hit the targeted funds rate, in the hope that changes in the federal funds rate will spread to other interest rates in the economy. An example of a recent federal funds rate target called for by the FOMC is shown in Exhibit 2–2.

EXHIBIT 2–1
Leading Primary Dealers Authorized to Trade Securities with the Federal Reserve in order to Assist with Monetary Policy April 2010

JP Morgan Securities, Inc.	Nomura Securities International, Inc.
Barclays Capital Inc.	UBS Securities LLC
Citigroup Global Markets, Inc.	Banc of America Securities LLC
Goldman Sachs & Co.	Credit Suisse Securities (USA) LLC
Mizuho Securities USA Inc.	HSBC Securities (USA) Inc.
BNP Paribus Securities Corp.	Cantor Fitzgerald & Co.
Federal Reserve Bank of New York	Daiwa Capital Markets America Inc.
Deutsche Bank Securities Inc.	Jeffries & Company, Inc.
Cantor Fitzgerald & Co.	RBS Securities Inc.
Morgan Stanley & Co., Incorporated.	RBC Capital Markets Corporation

Other Central Bank Policy Tools

Many central banks are an important source of *short-term loans* for depository institutions, especially for the largest banks, which tend to borrow frequently to replenish their reserves. For example, U.S. banks place signed borrowing authorizations at the Federal Reserve bank in their district for this purpose. When the Fed loans reserves

EXHIBIT 2–2

Example of a Federal Open Market Commmittee (FOMC) Statement, Setting a Target for the Federal Funds Rate to Be Achieved through Open Market Operations

Source: Minutes of FOMC Meeting, December 2009, Annual Report of the Board of Governors, pp. 388–389.

The vote encompassed approval of the statement below to be released at 2:15 p.m.:

"Information received since the Federal Open Market Committee met in November suggests that economic activity has continued to pick up and that the deterioration in the labor market is abating. The housing sector has shown some signs of improvement over recent months. Household spending appears to be expanding at a moderate rate, though it remains constrained by a weak labor market, modest income growth, lower housing wealth, and tight credit. Businesses are still cutting back on fixed investment, though at a slower pace, and remain reluctant to add to payrolls; they continue to make progress in bringing inventory stocks into better alignment with sales. Financial market conditions have become more supportive of economic growth. Although economic activity is likely to remain weak for a time, the Committee anticipates that policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will contribute to a strengthening of economic growth and a gradual return to higher levels of resource utilization in a context of price stability.

With substantial resource slack likely to continue to dampen cost pressures and with longer-term inflation expectations stable, the Committee expects that inflation will remain subdued for some time.

The Committee will maintain the target range for the federal funds rate at 0 to ¼ percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period. To provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets. the Federal Reserve is in the process of purchasing $1.25 trillion of agency mortgage-backed securities and about $175 billion of agency debt. In order to promote a smooth transition in markets, the Committee is gradually slowing the pace of these purchases, and it anticipates that these transactions will be executed by the end of the first quarter of 2010. The Committee will continue to evaluate the timing and overall amounts of its purchases of securities in light of the evolving economic outlook and conditions in financial markets.

Voting for this action: Messrs. Bernanke and Dudley, Ms. Duke, Messrs. Evans, Kohn, Lacker, Lockhart, Tarullo, and Warsh, and Ms. Yellen. Voting against this action: None."

Source: Board of Governors of the Federal Reserve System.

Key URL

The Federal Reserve's preferred measure of inflation is the U.S. Commerce Department's price index for personal consumption expenditures excluding food and energy (known as the PCE deflator less food and energy prices). See **www.bea.gov/national/consumer_spending.htm** for an explanation of how this inflation measure is constructed and a look at past data.

to borrowing institutions, the supply of legal reserves expands temporarily, which may cause loans and deposits to expand. Later, when these *discount window loans* are repaid, the borrowing institutions lose reserves and may be forced to curtail the growth of their deposits and loans. The loan rate charged by the Fed, the *discount rate*, is set by each Reserve bank's board of directors and must be approved by the Federal Reserve Board. In 2003 the Fed began setting the discount rate slightly above its target federal funds rate to promote greater stability. In 2007 and 2008 the Fed's discount window was opened wide in an effort to provide additional liquidity to banks under pressure from the home mortgage crisis.

Central banks also occasionally use *changes in reserve requirements* as a monetary policy tool. Institutions selling deposits (such as checking accounts) must place a small percentage of each dollar of those deposits in reserve, either in the form of vault cash or in a deposit at the central bank. Changes in the percentage of deposits and other funds sources that must be held in reserve can have a potent impact on credit expansion. Raising reserve requirements, for example, means that financial firms must set aside more of each incoming dollar of deposits into required reserves, and less money is available to support making new loans. Lowering reserve requirements, on the other hand, releases reserves for additional lending. Interest rates also tend to decline because financial institutions have more funds to loan. However, central banks usually change reserve requirements very infrequently because the impact can be so powerful and cannot easily be reversed and because banks are less dependent on deposits as a source of funds than in the past.

One other important policy tool that the Federal Reserve, the Bank of Japan, and other central banks use to influence the economy and the behavior of financial firms is

Real Banks, Real Decisions

THE CENTRAL BANKS OF CHINA AND JAPAN

China's central bank, the People's Bank of China (PBC), was formed from the combination of three domestic banks in 1948 and was officially designated as that nation's central bank in 1995. Until recently the PBC was both China's principal regulator of financial institutions and the conduit for that nation's monetary policy. It was the chief supervisor of domestic and foreign financial institutions selling services inside China, issued charters for new financial firms, dissolved failing ones, and regulated the entry of foreign banks. However, several of these important regulatory functions were handed over to the China Bank Regulatory Commission in 2003, leaving to the PBC the principal roles of conducting *monetary policy,* issuing currency and coin, regulating interbank lending and the bond markets, supervising China's payments system, and serving as the government's bookkeeper.

The PBC's monetary policy goals include maintaining the stability of the nation's currency, promoting sustainable economic growth, and controlling inflation. It pursues these objectives using changes in deposit reserve requirements, central bank loans, and open market operations. The PBC's pursuit of monetary policy is supported by an advisory group, the Monetary Policy Committee (MPC), which meets at least quarterly and includes the PBC's Governor, the Chair of the China Bank Regulatory Commission, the Finance Minister, and other members of the Chinese government. The PBC worked hard to cooperate with other leading central banks in 2008 to help fight a global credit crisis.

Considerably older is the Bank of Japan (BOJ), founded in 1882 and dedicated to ensuring price stability, a stable financial system, and sound economic development. The BOJ regulates the volume of money and interest rates through open market operations (using securities issued by the Japanese government and commercial bills), by providing emergency loans to institutions in trouble and through the use of moral suasion to convince financial managers to adhere to the BOJ's policies.

In addition to monetary policy the BOJ is responsible for issuing currency and coin, monitoring the nation's payments system, and conducting on-site examinations of financial-service firms. The BOJ receives and disburses Treasury funds and issues and redeems government securities. It may also intervene in the foreign exchange market on behalf of the Minister of Finance.

moral suasion. Through this policy tool the central bank tries to bring psychological pressure to bear on individuals and institutions to conform to its policies. Examples of moral suasion include central bank officials testifying before legislative committees to explain what the bank is doing and what its objectives are, letters and phone calls sent to those institutions that seem to be straying from central bank policies, and press releases urging the public to cooperate with central bank efforts to strengthen the economy.

Besides the traditional policy tools of open market operations, discount rates, reserve requirements, and moral suasion the Federal Reserve established two new policy tools in 2007 and 2008 to help stem the damage created by the home mortgage crisis. The Term Auction Facility (TAF) and the Term Securities Lending Facility (TSLF) were designed to make loans to depository institutions and securities dealers for periods of approximately one month to increase the supply of liquidity in the financial markets and expand credit for businesses and consumers. Four other central banks—the British, Canadian, Swiss, and European central banks—supported the Fed's action and moved in parallel fashion to encourage their countries' banks to expand the supply of credit.

A Final Note on Central Banking's Impact on Financial Firms

Clearly, managers of financial firms must be fully aware of the impact of *both* government regulation and central bank monetary policy on their particular institutions. No financial institution's management can ignore the effects of these key government activities upon the value of a financial-service provider's assets, liabilities, and equity capital and upon the magnitude of its revenues, expenses, and profits.

Concept Check

2–17. In what ways is the regulation of nonbank financial institutions different from the regulation of banks in the United States? How are they similar?

2–18. Which financial-service firms are regulated primarily at the federal level and which at the state level? Can you see problems in this type of regulatory structure?

2–19. Can you make a case for having only *one* regulatory agency for financial-service firms?

2–20. What is *monetary policy?*

2–21. What services does the Federal Reserve provide to depository institutions?

2–22. How does the Fed affect the banking and financial system through open market operations (OMO)? Why is OMO the preferred tool for many central banks around the globe?

2–23. What is a *primary dealer,* and why are they important?

2–24. How can changes in the central bank loan (discount) rate and reserve requirements affect the operations of depository institutions? What happens to the legal reserves of the banking system when the Fed grants loans through the discount window? How about when these loans are repaid? What are the effects of an increase in reserve requirements?

2–25. How did the Federal Reserve change the policy and practice of the discount window recently? Why was this change made?

2–26. How do the structures of the European Central Bank (ECB), the Bank of Japan, and the People's Bank of China appear to be similar to the structure of the Federal Reserve System? How are these powerful and influential central banks different from one another?

2–27. How did the Federal Reserve and selected other central banks expands their policy tools to deal with the great credit crisis of 2007–2009? Did their efforts work satisfactorily?

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Summary

What financial-service firms can do within the financial system is closely monitored by *regulation*—government oversight of the behavior and performance of financial firms. Indeed, financial-service institutions are among the most heavily regulated of all industries due, in part, to their key roles in attracting and protecting the public's savings, providing credit to a wide range of borrowers, and creating money to serve as the principal medium of exchange in a modern economy. The principal points in this chapter include:

- Financial-services regulations are created to implement federal and state laws by providing practical guidelines for financial firms' behavior and performance. Among the key U.S. laws that have had a powerful impact on the regulation of banks and competing financial institutions are the National Bank Act (which authorized federal chartering of banks), the Glass-Steagall Act (which separated commercial and investment banking), the Riegle-Neal Interstate Banking and Branching Efficiency Act (which allowed banking firms to branch across state lines), the Gramm-Leach-Bliley Act (which repealed restrictions against banks, security firms, and insurance companies affiliating with each other), the Sarbanes-Oxley Accounting Standards Act (which imposed new rules upon the financial accounting practices that financial firms and other publicly held businesses use), the Bank Secrecy and USA Patriot Acts (which required selected financial-service providers to gather and report customer information to the government in order to prevent terrorism and money laundering), the Check 21 Act (which allows the conversion of paper checks into electronically transferable payment items), the Fair and Accurate Credit Transactions (FACT) Act (which promised greater public access to credit bureau reports and made it easier for consumers to report and fight identity theft), and the Dodd-Frank Regulatory Reform Act of 2010 (which established a broad spectrum of new government rules to deal with systemic risk and promote fairness and transparency in accessing financial services).

- Regulation of financial firms takes place in a *dual system* in the United States—*both* federal and state governments are involved in chartering, supervising, and examining selected financial-service companies.
- The key federal regulators of banks include the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve System (FRS), and the Office of the Comptroller of the Currency (OCC). The OCC supervises and examines federally chartered (national) banks, while the FRS oversees state-chartered banks that have elected to join the Federal Reserve System. The FDIC regulates state-chartered banks that are *not* members of the Federal Reserve System. State regulation of banks is carried out in the 50 U.S. states by boards or commissions.
- Nonbank financial-service providers are regulated and supervised either at the state or federal government level or both. Examples include credit unions, savings associations, and security firms where state boards or commissions and federal agencies often share regulatory responsibility. In contrast, finance and insurance companies are supervised chiefly by state agencies. The chief federal regulatory agency for credit unions is the National Credit Union Administration (NCUA), while the Office of Thrift Supervision (OTS) oversees savings and loans and federally chartered savings banks. Security brokers, dealers, and investment banks are usually subject to supervision by the Securities and Exchange Commission (SEC) and state commissions.
- *Deregulation* of financial institutions is a new and powerful force reshaping financial firms and their regulators today in an effort to encourage increased competition and greater discipline from the marketplace. Even as deregulation has made progress around the world, key regulatory issues remain unresolved. For example, should banking and industrial companies be kept separate from each other to protect the safety of the public's funds? Do we need fewer regulators as the number of independently owned financial firms continues to fall or tighter regulation to reduce volatility in the financial-services marketplace?
- *Reregulation*, stressing new tougher government rules, appeared in the 21st century, especially following the great credit crisis of 2007–2009. Led by the Dodd-Frank Regulatory Reform Act new federal departments and offices were set up to protect consumers of financial services and provide cushions against risk, especially risk that reaches across the global financial marketplace.
- One of the most powerful of all financial institutions in the financial system is the *central bank*, which regulates money and credit conditions (i.e., conducts *monetary policy*) using such tools as open market operations, short-term loans, and legal reserve requirements. Central banks have a powerful impact upon the profitability, growth, and viability of financial-service firms and work to stabilize the economy and financial system.

Key Terms

dual banking system, *29*
state banking commissions, *30*
Comptroller of the Currency, *32*
Federal Reserve System, *32*
Glass-Steagall Act, *33*
Federal Deposit Insurance Corporation, *33*
Federal Deposit Insurance Corporation Improvement Act, *33*
Riegle-Neal Interstate Banking and Branching Efficiency Act, *37*
Gramm-Leach-Bliley Act, *38*
USA Patriot Act, *39*
Sarbanes-Oxley Accounting Standards Act, *40*

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National Credit Union Administration, *49*
Office of Thrift Supervision, *49*
Securities and Exchange Commission, *50*
state insurance commissions, *50*
systemic risk, *50*
Dodd-Frank Financial Reform Law, *51*
monetary policy, *52*
European Central Bank (ECB), *52*
Bank of Japan, *52*
People's Bank of China, *52*
Board of Governors, *53*
Federal Open Market Committee (FOMC), *53*
open market operations (OMO), *53*
Federal Reserve Bank, *53*
member banks, *53*

Problems and Projects

1. For each of the actions described, explain which government agency or agencies a financial manager must deal with and what laws are involved:
   a. Chartering a new bank.
   b. Establishing new bank branch offices.
   c. Forming a bank holding company (BHC) or financial holding company. (FHC).
   d. Completing a bank merger.
   e. Making holding company acquisitions of nonbank businesses.
2. See if you can develop a good case *for* and *against* the regulation of financial institutions in the following areas:
   a. Restrictions on the number of new financial-service institutions allowed to enter the industry each year.
   b. Restrictions on which depository institutions are eligible for government-sponsored deposit insurance.
   c. Restrictions on the ability of financial firms to underwrite debt and equity securities issued by their business customers.
   d. Restrictions on the geographic expansion of banks and other financial firms, such as limits on branching and holding company acquisitions across state and international borders.
   e. Regulations on the failure process, defining when banks and other financial firms are to be allowed to fail and how their assets are to be liquidated.
3. Consider the issue of whether or not the government should provide a system of deposit insurance. Should it be wholly or partly subsidized by the taxpayers? What portion of the cost should be borne by depository institutions? By depositors? Should riskier depository institutions pay higher deposit insurance premiums? Explain how you would determine exactly how big an insurance premium each depository institution should pay each year. When was the maximum value of federal deposit insurance last changed? By what amount?
4. The Trading Desk at the Federal Reserve Bank of New York elects to *sell* $100 million in U.S. government securities to its list of primary dealers. If other factors are held constant, what is likely to happen to the supply of legal reserves available? To deposits and loans? To interest rates?
5. Suppose the Federal Reserve's discount rate is 4 percent. This afternoon the Federal Reserve Board announces that it is approving the request of several of its Reserve banks to raise their discount rates to 4.5 percent. What is likely to happen to other interest rates tomorrow morning? Carefully explain the reasoning behind your answer.

   Would the impact of the discount rate change described above be somewhat different if the Fed simultaneously sold $100 million in securities through its Trading Desk at the New York Fed?

6. Suppose the Fed *purchases* $500 million in government securities from a primary dealer. What will happen to the level of legal reserves in the banking system and by how much will they change?
7. If the Fed loans depository institutions $200 million in reserves from the discount windows of the Federal Reserve banks, by how much will the legal reserves of the banking system change? What happens when these loans are repaid by the borrowing institutions?
8. What happens when a central bank like the Federal Reserve expands its assets? Is there any upper limit to a central banks assets? Why?

Internet Exercises

1. Does the banking commission or chief bank regulatory body in your home state have a website? What functions does this regulatory agency fulfill? Does it post job openings?
2. What U.S. banking laws have been important in shaping American history? (See **www.fdic.gov**.)
3. Have you ever wanted to be a bank examiner? What do bank examiners do? See if you can prepare a job description for a bank examiner. (See, for example, **www.federalreserve.gov** and/or watch the video at **www.occ.gov/about/careers/index-careers.html**.)
4. One of the key financial regulators in Europe is Britain's Financial Services Authority. (See **www.fsa.gov.uk**.) What are its principal activities?
5. What does it take to become a central banker? What does the job entail, and what kind of training do you think you should have (perhaps to become a member of the Federal Reserve Board)? (See **www.federalreserve.gov**.)
6. Can you describe the structure and mission of the European Central Bank (ECB)? The Bank of Japan? The People's Bank of China? Do any of these central banks resemble the structure of the Federal Reserve System? In what ways? (See especially **www.ecb.int**, **www.boj.or.jp/en/** and **www.pbc.gov.cn/english/**.)
7. Compare the federal regulatory agencies that oversee the activities and operations of credit unions, savings and loan associations and savings banks, and security brokers and dealers. In what ways are these regulatory agencies similar and in what ways do they seem to differ from each other? (See, for example, the websites **www.ncua.gov**, **www.ots.treas.gov**, and **www.sec.gov**.) As a result of recent federal legislation what is supposed to happen to the Office of Thrift Supervision (OTS)?

REAL NUMBERS FOR REAL BANKS — Continuing Case Assignment for Chapter 2

THE REGULATORY INFLUENCE ON YOUR BANKING COMPANY

In Chapter 2, we focus on the *regulations* that created and empowered today's regulators and that govern how and where financial institutions may operate and on what those operations may entail. For this segment of your case analysis we will add information to the Excel spreadsheet created in Assignment 1, using some of the terminology from the regulations discussed in this chapter and becoming familiar with the FDIC's website.

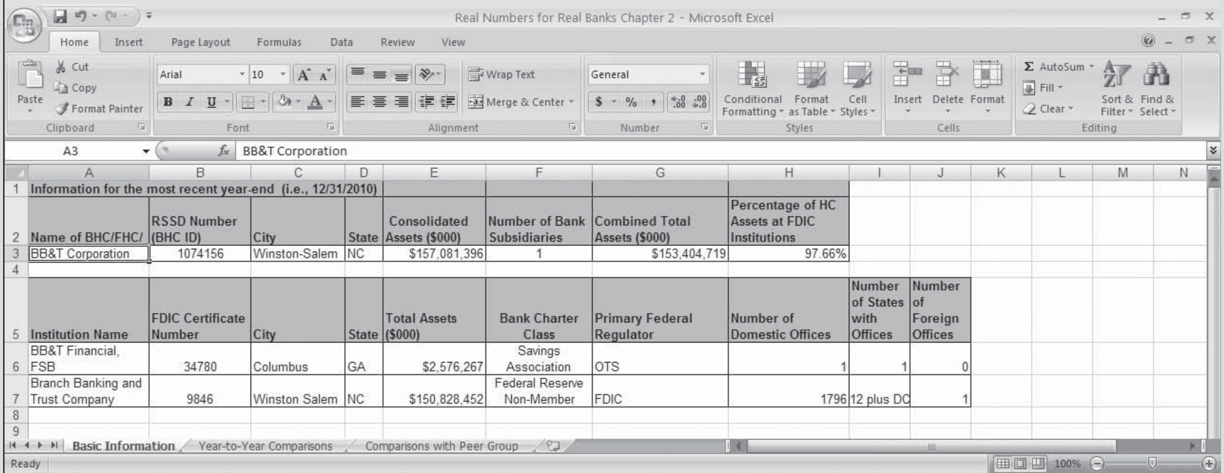
A. Go to the FDIC's Institution Directory at **www3.fdic.gov/idasp/** and search for your BHC using the RSSD number (also called the BHC ID #) obtained in Assignment 1. After clicking the "Find" button you will see data for your BHC. Make sure you utilize the pull-down menu to select the most recent year-end information. From this Web page collect data on combined total assets and add it to your Excel spreadsheet as illustrated. The information found at the FDIC site when labeled as BHC information is the aggregate of all FDIC-insured bank and thrift subsidiaries. The FDIC collects information only for the FDIC-insured institutions and does not provide information for the subsidiaries and affiliates that are neither banks nor thrifts. With the information you have collected use your Excel formula

REAL NUMBERS FOR REAL BANKS — Continuing Case Assignment for Chapter 2 *(continued)*

functions to compute the percentage of your holding company assets held at FDIC-insured institutions.

B. After collecting data for the BHC, explore the information provided for bank and thrift subsidiaries. Enter the information identified in the illustrated Excel worksheet. Click on the "Cert" links to find the information about bank charter class and primary federal regulator. Then from the Institution page accessed using the "Cert" link click on the "Current List of Offices" to gather the remaining information. Your collected information should be entered into your Excel spreadsheet as shown below (once again, the illustration is for BB&T of Winston-Salem, North Carolina using December 31, 2007 data):

What have we accomplished? We have begun to organize information and become familiar with the FDIC's website. (Make sure that you provide an appropriate title for the spreadsheet and label the columns.) In Chapter 3 we will be focusing on organization and structure, and you will be able to relate your banking company to the industry as a whole. (We always have something to look forward to!)



Information for the most recent year-end (i.e., 12/31/2010)									
Name of BHC/FHC/	RSSD Number (BHC ID)	City	State	Consolidated Assets ($000)	Number of Bank Subsidiaries	Combined Total Assets ($000)	Percentage of HC Assets at FDIC Institutions		
BB&T Corporation	1074156	Winston-Salem	NC	$157,081,396	1	$153,404,719	97.66%		
Institution Name	FDIC Certificate Number	City	State	Total Assets ($000)	Bank Charter Class	Primary Federal Regulator	Number of Domestic Offices	Number of States with Offices	Number of Foreign Offices
BB&T Financial, FSB	34780	Columbus	GA	$2,576,267	Savings Association	OTS	1	1	0
Branch Banking and Trust Company	9846	Winston Salem	NC	$150,828,452	Federal Reserve Non-Member	FDIC	1796	12 plus DC	1

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12. Walter, John R. "Banking and Commerce: Tear Down the Wall?" *Economic Quarterly*, Federal Reserve Bank of Richmond, 89, no. 2 (Spring 2003), pp. 7–31.

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Appendix

Central Bank Monetary Policy: Two Targets and The Great Recession of 2007–2009

The powerful monetary policy tools that central banks, such as the Federal Reserve and Europe's ECB, use to impact the economy and the growth and earnings of financial firms came into heavy use as the new century unfolded. Leading central banks used open market operations and their other policy tools to target two key elements of the financial marketplace:

1. *Changes in short-term interest rates* against which a central bank often has a strong and immediate influence on the banking system; and
2. *Changes in liquidity as reflected in the size or composition of a central bank's balance sheet* through purchases or sales of securities, affecting a nation's monetary base and investment activity (a practice known as "Quantitative Easing" or QE).

For example, when the global recession of 2007–2009 struck, unemployment soared, and business sales melted, the Federal Reserve set a target range for the short-term Federal funds interest rate of 0 to 0.25 percent. The Fed used open market operations (discussed earlier in this chapter), trading prominently in shorter-term governments and overnight loans, to push the Fed funds rate down to the desired range and hold it there. This low short-term interest rate target encouraged banks and other investors to borrow cash reserves and invest those cheap funds to help boost economic activity. Thus, the Fed flooded the banking system with excess reserves, which allowed short-term interest rates to move toward zero and hover there, but limited this tool's effective long-term impact on the economy. Another policy tool seemed to be needed.

As the months went by and both job growth and investment activity remained weak, the Fed used a different tool that the Bank of Japan, the Swedish and Swiss central banks, and other monetary institutions had used a few years earlier. The Fed began buying longer-term financial instruments, roughly tripling the size of its balance sheet. It launched this "Quantitative Easing" tool by purchasing large quantities of longer-term government and mortgage-backed securities. The idea behind this QE exercise was to target principally longer-term interest rates, especially rates on U.S. government bonds and mortgage instruments. Most importantly the Fed sought to keep home mortgage interest rates low, to encourage home owners to find ways to keep their homes, and to stimulate builders to revive faltering construction activity, creating more jobs.

By using both tools the Fed went after both ends of the yield curve, targeting shorter-term-interest rates to build up the reserves of the banking system and targeting longer-term interest rates to stimulate long-term business investment activity and the mortgage market.

The two-pronged approach that the Fed and other central banks have followed has had a profound effect on banking and financial services. Banks were flooded with reserves, gaining cheap money to make loans and investments. At the same time banks looked stronger because they had more cash to work with and their capital stayed at relatively high levels. With more reserves and capital on hand to cover expenses, banks and other lenders were able to write off more bad loans and sought struggling companies to acquire.

Unfortunately, however, while the financial sector seemed to be recovering, the real sector, encompassing manufacturing, transportation, mining, exploration, and construction, continued to flounder. When dealing with serious economic problems the real and financial sectors must *both* contribute to economic recovery, employment, and price stability. Regretfully, the central bank tools we have just discussed leave many questions unanswered about which monetary policy strategy is likely to be most effective in solving the economy's many problems. (See, for example, Anderson et al. [15] and Blinder [16].)