

Chapter 14

Regulating the Financial System

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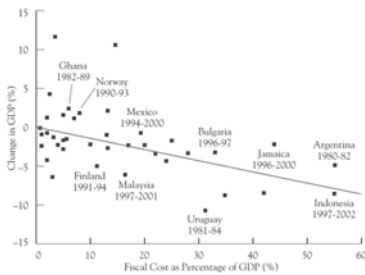
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Table 14.1 Worst Banking Crises since 1980

Country	Crisis Dates	Estimated Cost of Resolution (as % of GDP)
Argentina*	1980–1982	55%
Indonesia*	1997–1998	55%
China	1990s	47%
Jamaica*	1994	44%
Chile*	1981–1983	42%
Thailand*	1997	35%
Macedonia	1993–1994	32%
Israel	1977–1983	30%
Turkey*	2000	30%
Uruguay	1981–1984	29%
Korea	1998	28%
Côte d'Ivoire	1988–1991	25%
Japan	1990s	24%
Uruguay	1981–1984	24%
Malaysia*	1997–1998	20%

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Figure 14.1 Relationship between Size of a Financial Crisis and Change in GDP Growth



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The Sources and Consequences of Runs, Panics, and Crises

- Insolvent
- Bank Run
- Illiquid
- Bank panic

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The Government Safety Net

- There are three reasons for the government to get involved in the financial system
 - to protect investors.
 - to protect bank customers from monopolistic exploitation.
 - to ensure the stability of the financial system

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The Government Safety Net

- the lender of last resort
 - an institution would be capable of making loans to prevent the failure of solvent banks, and could provide liquidity in sufficient quantities to prevent or end a financial panic
- deposit insurance
 - a depositor will receive the full account balance up to some maximum amount, even if a bank fails

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The Government Safety Net

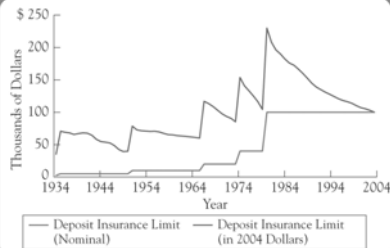
- FDIC and Bank Failure
 - the payoff method
 - pays off all the bank's depositors, then sells all the bank's assets in an attempt to recover the amount paid out
 - the purchase and assumption method
 - FDIC finds a firm that is willing to take over the failed bank. The FDIC sells the failed bank at a negative price.

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The Government Safety Net

Figure 14.4 Nominal and Inflation-Adjusted Deposit Insurance Limits



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The Government Safety Net

- Problems Created by the Government Safety Net
 - bankers take on more risk than they would normally, since they get the benefits while the government assumes the costs
 - government's too-big-to-fail policy limits the extent of the market discipline depositors can impose on banks

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Regulation and Supervision of the Financial System

Table 14.2 Regulators of Depository Institutions

Type of Intermediary	Regulators
Commercial Banks	<ol style="list-style-type: none"> 1. Federal Deposit Insurance Corporation 2. Office of the Comptroller of the Currency (Nationally chartered banks) 3. Federal Reserve System (State-chartered banks that are Federal Reserve members) 4. State authorities (All state-chartered banks)
Savings Banks Savings and Loans	<ol style="list-style-type: none"> 1. Office of Thrift Supervision 2. Federal Deposit Insurance Corporation 3. State authorities
Credit Unions	<ol style="list-style-type: none"> 1. National Credit Union Administration 2. State authorities

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Regulation and Supervision of the Financial System

- Restrictions on Competition
 - Bank mergers still require government approval. Before granting it, officials must be convinced on two points.
 - First, the new bank must not constitute a monopoly in any geographic region.
 - Second, if a small community bank is to be taken over by a large regional bank, the small bank's customers must be well served by the merger

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Regulation and Supervision of the Financial System

- Asset Holding Restrictions and Minimum Capital Requirements
 - asset holding restrictions
 - U.S. banks cannot hold common stock
 - generally prohibited from purchasing bonds that are below investment grade
 - any single private issuer cannot exceed 25 percent of their capital
 - Capital Requirements
 - keep their ratio of capital to assets above some minimum level
 - hold capital in proportion to the risk level of their operations

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Regulation and Supervision of the Financial System

- Disclosure Requirements
 - Banks are required to provide information, both to their customers about the cost of their products and to the financial markets about their balance sheets.

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Regulation and Supervision of the Financial System

- Supervision and Examination
 - The government enforces banking rules and regulations through an elaborate oversight process called supervision.
 - Every depository institution that is insured by the FDIC is examined at least once a year.
 - CAMELS
 - Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to risk

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Chapter 14

End of Chapter
