United States Acts

A deep-rooted feeling in the U.S. is to fear concentrated financial structures. Early on, many were afraid that large federal institutions would concentrate financial powers and to be used to benefit the owners at the expense of the general public.

> Anti-Trust Laws:
> They are laws that restrict the size and economic power that a single firm may hold in a geographic or economic market.

The Free bank Act of 1850 [Populist Approach]

- Allowed banks to be formed without state charter provided that new banks would purchase a specific amount of state bonds which in turn served as an upper limit on the bank's note issue.
- Did not allow branching

Pre-Depression

National Bank Act of 1863 (NBA)

- Created a unique system of banking regulation
- Established the Office of the Comptroller of the Currency (OCC).

The duties of OCC are:

1. To supervise all national banks
2. To grant federal charters
3. To impose new capital requirement on banks
4. To impose reserves
5. To restrict types of loans and amounts (e.g., banks cannot lend more than 10 percent to single borrower of banks' capital stock).

Note that OCC have the power to grant a bank a federal charter. At the moment of its inception, a bank may seek a state charter or a federal charter. If the bank seeks a federal charter, OCC may approve it and grant it and the bank becomes a national bank. If the bank seeks a state charter, the state government may approve it and grant it. This dual system is still in effect until today.

> System of Dual-Regulation in the U.S.
> This system is defined by the existence of two regulating bodies for banks. National banks fall under the regulations and supervision of OCC and state laws. State banks fall under the regulations and supervision of state laws only.

Federal Reserve Act of 1913

- Established the Federal Reserve System.
- Imposed reserve requirements to all banks (National and State) to avoid bank panics (Bank panics occurred in 1873 and in 1907).

The Edge Act of 1919

- Permitted Federal charting of banks for the sole purpose of international banking.

The Pepper-McFadden Act of 1927 (also known as the McFadden Act)
(The act was amended in 1933)

- Leveled the playing field between national and state banks.
- Prohibited banks from branching across state lines
- Gave national banks the right to open branches in states that permitted bank branches (Note that if the state had a unit branching law then national banks had to abide and restrict its branches to one).

Out of the pre-Depression era, one concludes that the purpose of regulations was, 1) to settle differences between national and state banks and 2) to avoid bank panics. The outcome of the pre-Depression regulations was a strong dual-system for banks.

Post-Depression

Banking Act of 1933 (Glass-Steagall Act)
The act was initiated by Senator Carter Glass and Representative Steagall.

- Restricted bank activities and control their borrowing
- Provided guarantees to depositors
- Prohibited banks from acting as investment banks (investment dealers), as broker and as dealer in securities transactions (i.e., prohibited banks from underwriting securities). The exception to this prohibition on financial' instruments transactions was, federal government securities, municipal bonds and bank securities.
- Established the Federal Deposit Insurance Corporation (FDIC)
- Imposed regulation Q

  Regulation Q:
  - Prohibited payment of interest on demand deposits
  - Restricted the level of interest to be paid on time and saving deposits

  Regulation Q aimed to increase banks' profitability by setting a ceiling on deposits' interests but none on lending interests.

- The FDIC guaranteed up to $10,000 of the deposit, 75 percent of the next $40,000 and 50 percent of the next $50,000. Today FDIC guarantees up to $100,000.
- Bank Holding Companies (BHC) surged to circumvent the third clause of the act.

Home Owners' Loan Act of 1933

The act applied only to thrift industry, which was state chartered only.

- Permitted the formation of Savings & Loan Associations at the federal level.
- Permitted voluntary conversion of state charters to national charters
- Authorized the Federal Home Loan Bank Board (FHLBB) to regulate thrift institutions.

The FHLBB played a similar role to OCC. Today, the FHLBB system has 12 regional offices (The Board was abolished in 1989 and its functions were assigned to the Office of Thrift Supervision OTS).

National Housing Act of 1934

- Established the Federal Saving & Loan Insurance Corporation (FSLIC) [pronounced fizz-lick] under the administration of FHLBB.
- The FSLIC role is to insure state and national Savings & Loan Associations (S&L).

The following states have their own FSLIC, Massachusetts, Ohio and Maryland.

The Bank Holding Company Act of 1956 (BHC)

- Defined BHC as any organization that owns, controls, holds with power to vote more than 25 percent or more of a banks' voting shares
- Allowed BHC to circumvent geographic restrictions on branching
- Allowed BHC to engage in activities not allowed to banks, such as mutual funds sale and loan mortgages.
- Brought One-Bank Holding Company (OBHC) and Multiple-Bank Holding Company (MBHC) under federal regulations.
- Required existing MBHC to register with the Federal Reserve.
- Required newly created MBHC to seek prior approval by the Federal Reserve

The act gave the Federal Reserve authority to restrict the non-banking activities of the MBHC.

Bank Mergers Acts of 1960 and 1966

Prior to 1966, bank mergers were not subject to Antitrust laws.

- Required mergers to be approved by
  - OCC for national banks
  - The Federal Reserve for state banks members of the Federal Reserve
  - The FDIC for state banks not members of the Federal Reserve

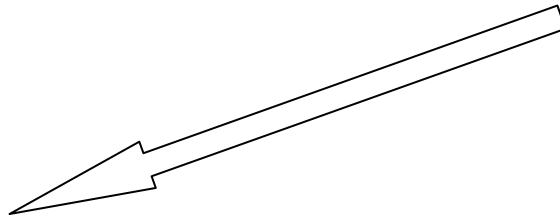
The acts gave importance to the competitive effects of mergers on other existing banks. Any merger that reduced competition among banks will be rejected. The act defined the conditions under which a bank merger can be approved.

The Douglas Amendment to the Bank Holding Company Act of 1970

- Brought OBHC under the same regulations of MBHC, i.e., to register with the Federal Reserve
- Specified that BHC activities must be 'closely related to banking'

The Depression brought tighter regulations. The high market rate of the 1970s spurred the mutual funds industry. The disintermediation of the 1970s resulted in the surge of the mutual funds and induced the decision to deregulate the financial sector.

Depression ⟹ Regulations ⟹ 1970s and early 1980s high interest rates



Disintermediation ⟹ Deregulations

Deregulation

The process of deregulation freed interest rates deposits ceiling and allowed higher risk taking business activities.

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

- Abandon regulation Q by phasing out deposits ceiling rates by 1986
- Permitted thrift institutions and credit unions to offer nationwide checking accounts.
  A checking account at thrift institutions is called 'negotiated order of withdrawal' (NOW account)
  A checking account at credit unions is called 'draft account'
- Granted federally chartered S&L Associations new investment powers (e.g., to invest in corporate bonds and commercial papers)
- Allowed the increase of the permitted size of the loan from S&L Associations to resident from $75,000 to 90 percent of the value of the residency
- Allowed S&L Associations to make construction loans

- Removed all geographic restrictions on real estate lending by S&L Associations
- Permitted S&L Associations to,
  - Offer consumer loans
  - Issue credit cards
  - Make commercial loans up to 5 percent of their assets
  - Accept commercial demand deposits
- Imposed a uniform reserve requirement on all deposit taking institutions.
- Increased deposit insurance to $100,000 per account

The objectives of DIDMCA were to,

1. Phase out regulation Q
2. Relax restrictions on types of loans savings banks can offer (i.e., to increase the portfolio diversification by commercial lending)
3. Impose uniform reserve requirements for all deposits taking institutions (DI)
4. Allow DI to borrow from the Federal Reserve

The Garn-St Germain Deposit Taking Institutions Act of 1982

- Freed DI of the remaining restrictions on their powers
- Allowed banks and S&L to offer Money Market Deposit Accounts (MMDA)
- Allowed savings banks and S&L to make commercial loans up to 30 percent of their assets
- Permitted thrift institutions to invests up to 40 percent of their assets in loans secured by commercial real estate
- Gave the FDIC and the FSLIC emergency powers to merge banks and thrifts across state lines

Design Flaws in the system from 1933 – 1982

1. Encouraged inappropriate investment decisions (e.g., Moral Hazard)
2. Attracted managers to cause disasters (e.g., Adverse Selection)
3. Did not allow large banks to fail ('Too Big To Fail Policy')
4. Encouraged 'Faulty Pricing'.

Moral hazard is the negative incentives of the contract. Once the contract is signed there are negative externalities. For example, if the car radio is insured, then one can leave the car unlocked. Another example, the depositor has no incentives to investigate the investment done by the bank or the S&L association.

Adverse selection takes place before the contract is signed. A fully insured system might attract dishonest managers who invest in risky business.

The 'Too Big to Fail' policy was applied in 1984 with regards to 'Continental Illinois' which became insolvent. The FDIC guaranteed all deposits. The same policy was practiced for the 'Bank of New England' in 1990.

Faulty pricing is the concept that policies price fails to reflect the risk of the insured. Under the 1933-1982 system, each financial institution was subject to the same premium rate regardless of its business. To understand 'faulty pricing' think of the car insurance premium you pay. Young drivers pay higher premiums. Such a system is not subject to faulty pricing. If all drivers paid the same premium rates then such a system can be labeled as 'faulty pricing'.

By mid 1980s, many financial institutions became insolvent due to the design flaws. As a solution, federal regulators practiced the following,

1. Regulatory forbearance (tolerance), i.e., they permitted insolvent institutions to continue practice [no one wanted bad news].
2. Merged failing institutions.
3. Institutional zombies, i.e., they allowed zombies to exist in the system.
4. A new round of regulations.

In 1982, due to the competition between banks and MMMF for deposits, depository institutions were allowed to offer money market deposit accounts (MMDAs) – very short-term deposits - paying competitive interest rates on small sums that were federally insured.

By 1987, the FSLIC was bankrupt.

THE NEW RULES

Competitive Equality in the Banking Act of 1987 (CEBA)

- Allowed the FSLIC to raise additional $10.8 billion of new funds
- Restricted the FSLIC to spend no more than $3.7 billion each year on failing institutions
- Changed the definition of 'Bank' to include FDIC insured institutions

In 1988, the U.S. Supreme Court allowed the Federal Reserve to authorize bank affiliates to underwrite commercial papers, municipal bonds, and mortgage-backed securities.

In 1988, regulators from the Group of Ten (G-10[1]) countries adopted risk-based capital standards. These standards classify assets according to credit risk.

[1] The G-10 countries are Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States.

In June 1989, the Federal Reserve authorized (some) bank holding companies to underwrite corporate bonds.

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

- Abolished the FHLBB and the FSLIC
- Created the 'Office of Thrift Supervision (OTS)' as part of the Treasury Department to parallel the OCC in its functions
- The functions of the FSLIC were assigned to the FDIC, which became the only insurer for banks and thrift institutions
- Created two insurance funds
    1. Bank Insurance Fund (BIF) to insure banks
    2. Savings & Loans Insurance Funds (SAIF) to insure thrifts

    For each $100 insured, BIF received 12 cents as premiums and SAIF received 20.8 cents. From 1991 to 1993, BIF became insolvent. In 1998, each received the same rate set at 15 cents.
- Created the 'Resolution Trust Corporation (RTC)' to manage the dissolution of failed thrifts and to liquidate its assets.

    "The RTC is the Angel of Death"
- Permitted thrifts to apply for a charter similar to banks
- Decreed thrifts to keep 70 percent of their assets in housing-related assets
- Permitted BHC to acquire thrifts
- Provided new definition for 'Capital' and new capital requirements for banks and thrifts
- Gave more intervention power to regulators

Note that the act re-imposed restrictions on S&L associations activities and raised deposits insurance premiums.

Crime Control Act of 1990

Title XXV of the Crime Control Act, known as the Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990, greatly expanded the authority of Federal regulators to combat financial fraud.
This act increased penalties and prison time for those convicted of bank crimes, increased the powers and authority of the FDIC to take enforcement actions against institutions operating in an unsafe or unsound manner, and gave regulators new procedural powers to recover assets improperly diverted from financial institutions.

FDIC Improvement Act of 1991 (FDICIA)

- Decreed the FDIC to be more risk-based in its assessment of DI fees starting in 1994
- Allowed earlier intervention of FDIC into troubled institutions by setting provisions for prompt corrective actions

- Limited the scope of the 'Too Big to Fail Policy'
- Strengthened the Fed's authority to supervise foreign banks

Housing and Community Development Act of 1992

The act established the regulatory structure for government-sponsored enterprises (GSEs), combated money laundering, and provided regulatory relief to financial institutions.

Riegle Community Development and Regulatory Improvement Act of 1994

- Established a Community Development Financial Institutions Fund (CDFI), a wholly owned government corporation that would provide financial and technical assistance to CDFIs.
- Contains several provisions aimed at curbing the practice of "reverse redlining" in which non-bank lenders target low and moderate income homeowners, minorities and the elderly for home equity loans on abusive terms.
- Relaxes capital requirements and other regulations to encourage the private sector secondary market for small business loans.
- Contains more than 50 provisions to reduce bank regulatory burden and paperwork requirements.
- Requires the Treasury Dept. to develop ways to substantially reduce the number of currency transactions filed by financial institutions.
- Contains provisions aimed at shoring up the National Flood Insurance Program.

Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994

- Permits adequately capitalized and managed bank holding companies to acquire banks in any state one year after enactment.
- Concentration limits apply and Credit Reporting Act (CRA) evaluations by the Federal Reserve are required before acquisitions are approved.
- Beginning June 1, 1997, allows interstate mergers between adequately capitalized and managed banks, subject to concentration limits, state laws and CRA evaluations.
- Extends the statute of limitations to permit the FDIC and RTC to revive lawsuits that had expired under state statutes of limitations.
- Overturned prohibition of interstate banking
- Allowed branching across state lines

In 1995, the Congress approved more de-regulations.

Economic Growth and Regulatory Paperwork Reduction Act of 1996

- Modified financial institution regulations, including regulations impeding the flow of credit from lending institutions to businesses and consumers.
- Amended the Truth in Lending Act and the Real Estate Settlement Procedures Act of 1974 to streamline the mortgage lending process.
- Amended the FDICIA (1991) to eliminate or revise various application, notice, and record keeping requirements to reduce regulatory burden and the cost of credit.
- Amended the Fair Credit Reporting Act (CRA) to strengthen consumer protections relating to credit reporting agency practices.
- Established consumer protections for potential clients of consumer repair services. Clarified lender liability and federal agency liability issues under the CERCLA.
- Directed FDIC to impose a special assessment on depository institutions to re-capitalize the SAIF, aligned SAIF assessment rates with BIF assessment rates and merged the SAIF and BIF into a new Deposit Insurance Fund.

Gramm-Leach Bliley Act of 1999

- Repeals last vestiges of the Glass-Steagall Act of 1933.
- Modifies portions of the Bank Holding Company Act to allow affiliations between banks and insurance underwriters.
- While preserving authority of states to regulate insurance, the act prohibits state actions that have the effect of preventing bank-affiliated firms from selling insurance on an equal basis with other insurance agents.
- Created a new financial holding company under section 4 of the BHCA, authorized to engage in: underwriting and selling insurance and securities, conducting both commercial and merchant banking, investing in and developing real estate and other "complimentary activities." There are limits on the kinds of non-financial activities these new entities may engage in.
- Allows national banks to underwrite municipal bonds.
- Restricts the disclosure of nonpublic customer information by financial institutions. All financial institutions must provide customers the opportunity to "opt-out" of the sharing of the customers' nonpublic information with unaffiliated third parties.
- The Act imposes criminal penalties on anyone who obtains customer information from a financial institution under false pretenses.
- Amends the Community Reinvestment Act to require that financial holding companies can not be formed before their insured depository institutions receive and maintain a satisfactory CRA rating. Also requires public disclosure of bank-community CRA-related agreements.
- Grants some regulatory relief to small institutions in the shape of reducing the frequency of their CRA examinations if they have received outstanding or satisfactory ratings. Prohibits affiliations and acquisitions between commercial firms and unitary thrift institutions.

- Makes significant changes in the operation of the Federal Home Loan Bank System (now under OTS), easing membership requirements and loosening restrictions on the use of FHLB funds.

The emergence of new markets and other technological innovations resulted in the outgrowth of competitive pressures. Computer-aided analytical techniques for investors were accessible to more businesses. The technological developments enhanced the cash management and funding of customers and the outgrowth of the commercial paper market.

In summary, changing conditions in the banking' business, gave a need to change legislation to allow competition on equal footing between DT institutions.