Government Policy and Regulation on the Financial-Services Industry
Key Topics

• The Principal Reasons for Banking and Financial-Services Regulation
• Major Financial-Services Regulators and Laws
• Some Key Regulatory Issues Left Unresolved
• The Central Banking System
Introduction

• 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
  ▫ Prevent abuse of financial-service customers

• Financial institutions must contend with some of the heaviest and most comprehensive rules applied to any industry

• Regulation is an ugly word to many people
  ▫ Burdensome
  ▫ Costly
  ▫ Damaging to innovation and efficiency
Banking Regulation

Why are banks closely regulated?

- Banks are among the leading repositories of the public’s savings
- Banks are closely watched because of their power to create money in the form of readily spendable deposits by making loans and investments
- Banks have a long history of involvement with federal, state, and local governments
- One of the earliest theories about regulation contends that firms in regulated industries actually seek out regulation. It brings benefits in the form of monopolistic rents because regulations often block entry into the regulated industry
- A more recent theory argues that regulations can increase customer confidence, which may create greater customer loyalty toward regulated firms

In the United States, banks are regulated through a dual banking system

- Both federal and state authorities have significant regulatory powers
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.
## Regulators of U.S. Insured Banks

<table>
<thead>
<tr>
<th>Types of U.S. Insured Banks</th>
<th>Number of U.S Insured Banks (as of 12/31/09)</th>
<th>Number of Branch Offices of Insured Banks (as of 12/31/09)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks chartered by the federal government:</td>
<td></td>
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<tr>
<td>U.S. insured banks with national (federal) charters issued by the Comptroller of the Currency</td>
<td>1,448</td>
<td>43,158</td>
</tr>
<tr>
<td>Banks chartered by state governments:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>State-chartered member banks of the Federal Reserve System and insured by the Federal Deposit Insurance Corporation</td>
<td>840</td>
<td>14,505</td>
</tr>
<tr>
<td>State-chartered nonmember banks insured by the Federal Deposit Insurance Corporation</td>
<td>4,520</td>
<td>23,613</td>
</tr>
<tr>
<td>Total of All U.S. Insured Banks and Branches</td>
<td>6,808</td>
<td>81,276</td>
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### Primary Federal Regulators of U.S. Insured Banks

<table>
<thead>
<tr>
<th>Number of U.S. Insured Banks under Direct Regulation</th>
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<tbody>
<tr>
<td>Federal Deposit Insurance Corporation (FDIC)</td>
</tr>
<tr>
<td>Office of the Comptroller of the Currency (OCC)</td>
</tr>
<tr>
<td>Board of Governors of the Federal Reserve System (BOG)</td>
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</tbody>
</table>
What is Regulated?

• Initial creation of depository institutions
  ✓ Initial licensing and chartering
  ✓ Location and number of physical branches, offices
  ✓ Initial board of directors and officers
  ✓ Minimum cash and capital requirements to open

• On-going operations
  ✓ Mergers and acquisitions
  ✓ Opening or closing of offices, branches
  ✓ Many operations procedures
  ✓ What financial services/products may be offered

• Assets
  ✓ Diversification of assets
  ✓ Quality of assets
  ✓ Liquidity of assets
  ✓ Level of cash reserves
What is Regulated? –Cont.

• Liabilities & equity
  ✓ Types of liabilities created
  ✓ Distribution of financing of assets
  ✓ Quality of liability and equity accounts
  ✓ Minimum capital requirements

• Others
  ✓ Community involvement
  ✓ Degree of market share in each market area
  ✓ Non-discriminatory operating policies

• Regulatory Process
  ✓ Examinations
  ✓ Reports
  ✓ CAMELS Rating: C apital adequacy; A sset Quality; M anagement Quality; E arnings – amount & stability; L iquidity; S ensitivity to market risk
Major Banking Laws – Where and When the Rules Originated

- 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.
Major Banking Laws – Where and When the Rules Originated (continued)

• The Federal Reserve Act (1913)
  – A series of financial panics in the late 19th and early 20th centuries led to the creation of the Federal Reserve System (the Fed)
  – The Fed’s principal roles are to serve as a lender of last resort and to help stabilize the financial markets and the economy
  – Their most important job today is to control money and credit conditions to promote economic stability
Major Banking Laws – Where and When the Rules Originated (continued)

• The Banking Act of 1933 (Glass-Steagall)
  ▫ 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 Federal Deposit Insurance Corporation (FDIC) was created to guarantee the public’s deposits up to a stipulated maximum amount in order to enhance public confidence in the banking system
    ▫ Initially $2,500 and today it is up to $250,000
More......
Unresolved Regulatory Issues

- What should we do about the regulatory safety net set up to protect small depositors from loss, usually through government-sponsored deposit insurance?
- Can we train regulators to be as good as they need to be in a more complex financial marketplace?
- 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?
- As financial firms reach their arms around the globe, what nation or nations should regulate their activities?
The Regulation of Nonbank Financial-Service Firms Competing with Banks

- Credit Unions
  - National Credit Union Administration (NCUA)

- Savings and Loans and Savings Banks (“Thrifts”)
  - State-chartered associations are supervised and examined by state boards or commissions
  - Federally chartered savings associations fall under the jurisdiction of the Office of Thrift Supervision
    - The Dodd-Frank Act merged the Office of Thrift Supervision with the Office of the Comptroller of the Currency so that thrift institutions and national banks would have the same regulatory agency at the federal level

- Money Market Funds
  - Securities and Exchange Commission (SEC)
The Regulation of Nonbank Financial-Service Firms Competing with Banks (continued)

- Life and Property/Casualty Insurance Companies
  - State insurance commissions
  - Recently the federal government has become somewhat more involved in insurance
  - 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
  - Under the Dodd-Frank Act, a new federal insurance office 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
The Regulation of Nonbank Financial-Service Firms Competing with Banks (continued)

• Finance Companies
  ▫ Regulated at the state government level for many decades
  ▫ 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
  ▫ The passage of the Dodd-Frank Act in 2010 caused many to close as the maximum interest rates that these entities could charge was drastically reduced
The Regulation of Nonbank Financial-Service Firms Competing with Banks (continued)

- **Mutual Funds**
  - 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

- **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
  - The chief federal regulator is the SEC
    - Requires these firms to submit periodic reports, limits the volume of debt they take on, and investigates insider trading practices
The Regulation of Nonbank Financial-Service Firms Competing with Banks (continued)

- Hedge Funds, Private Equity Funds, and Venture Capital Companies
  - Some of the most lightly regulated of all financial institutions
  - The SEC in the United States 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
  - The Dodd-Frank Act of 2010 calls for greater separation between commercial banks and these riskier private investors

- The central bank of the United States is the Federal Reserve System (the Fed)
- A central bank’s primary job is monetary policy
  - 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
- The Fed is free to pursue these goals because it does not depend on the government for its funding
  - Passes along most of its earnings to the U.S. Treasury

- The European Union also have a central bank – the European Central Bank (ECB)
  - It 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
  - Several of these countries have experienced higher inflation rates, volatile currency prices, and other significant economic problems in recent years
- Recent research suggests 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)

- **Organizational Structure of the Federal Reserve System**
  - **Board of Governors**
    - 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).
    - The board regulates and supervises the activities of the 12 district Reserve banks and their branch offices.
    - It sets reserve requirements, approves all changes in the discount (loan) rates posted by the 12 Reserve banks, and takes the lead in the system in determining open market policy.

- **Organizational Structure of the Federal Reserve System**
  - **Federal Open Market Committee (FOMC)**
    - The Federal Reserve Board members make up a majority of the voting members of the 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
    - Primary task is to set policies that guide the conduct of open market operations
      - The buying and selling of securities by the Federal Reserve banks

- **Organizational Structure of the Federal Reserve System**
  - There are 12 districts contained in the Federal Reserve System, with a Federal Reserve Bank chartered in each district
  - Key services that the Federal Reserve banks offer to depository institutions in their districts:
    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”

- Organizational Structure of the Federal Reserve System
  - Key services that the Federal Reserve banks offer to depository institutions in their districts:
    5. Dispensing supplies of currency and coin
    6. Clearing and collecting checks and other cash items
    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

• 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
  ▫ 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
  ▫ 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

- The Open Market Policy Tool of Central Banking
  - Open market operations (OMO) have become the principal tool of central bank monetary policy
    - In the United States, OMO involves the buying and selling of 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

- **The Open Market Policy Tool of Central Banking**
  - Central bank sales of securities tend to decrease the growth of deposits and loans within the financial system
    - Interest rates tend to rise
  - In contrast, central bank purchases of securities tend to increase the growth of deposits and loans
    - Interest rates tend to fall
  - The 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
    - In the hope that changes in the federal funds rate will spread to other interest rates in the economy
Leading Primary Dealers Authorized to Trade Securities with the Federal Reserve in order to Assist with Monetary Policy (April 2010)

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<tr>
<td>Barclays Capital Inc.</td>
<td>UBS Securities LLC</td>
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<td>Citigroup Global Markets, Inc.</td>
<td>Banc of America Securities LLC</td>
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<tr>
<td>Goldman Sachs &amp; Co.</td>
<td>Credit Suisse Securities (USA) LLC</td>
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<tr>
<td>Mizuho Securities USA Inc.</td>
<td>HSBC Securities (USA) Inc.</td>
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<td>BNP Paribus Securities Corp.</td>
<td>Cantor Fitzgerald &amp; Co.</td>
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<tr>
<td>Federal Reserve Bank of New York</td>
<td>Daiwa Capital Markets America Inc.</td>
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<tr>
<td>Cantor Fitzgerald &amp; Co.</td>
<td>RBS Securities Inc.</td>
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<tr>
<td>Morgan Stanley &amp; Co., Incorporated.</td>
<td>RBC Capital Markets Corporation</td>
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Example of a Federal Open Market Committee (FOMC) Statement, Setting a Target for the Federal Funds Rate to Be Achieved through Open Market Operations

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.

• Other Central Bank Policy Tools
  – Many central banks are an important source of short-term loans for depository institutions

  – When the Fed loans reserves, the supply of legal reserves expands temporarily, which may cause loans and deposits to expand

    □ 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

- **Other Central Bank Policy Tools**
  - Central banks also occasionally use changes in reserve requirements as a monetary policy tool
  - Institutions must place a small percentage of each dollar of deposits in reserve, either in the form of vault cash or in a deposit at the central bank
  - Raising reserve requirements 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
    - On the other hand, lowering reserve requirements releases reserves for additional lending
  - Central banks rarely change reserve requirements
    - Powerful impact, cannot easily be reversed and because banks are less dependent on deposits as a source of funds

- Other Central Bank Policy Tools
  - One other important policy tool – 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
  - 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
  - Press releases urging the public to cooperate with central bank efforts to strengthen the economy