

CHAPTER 1

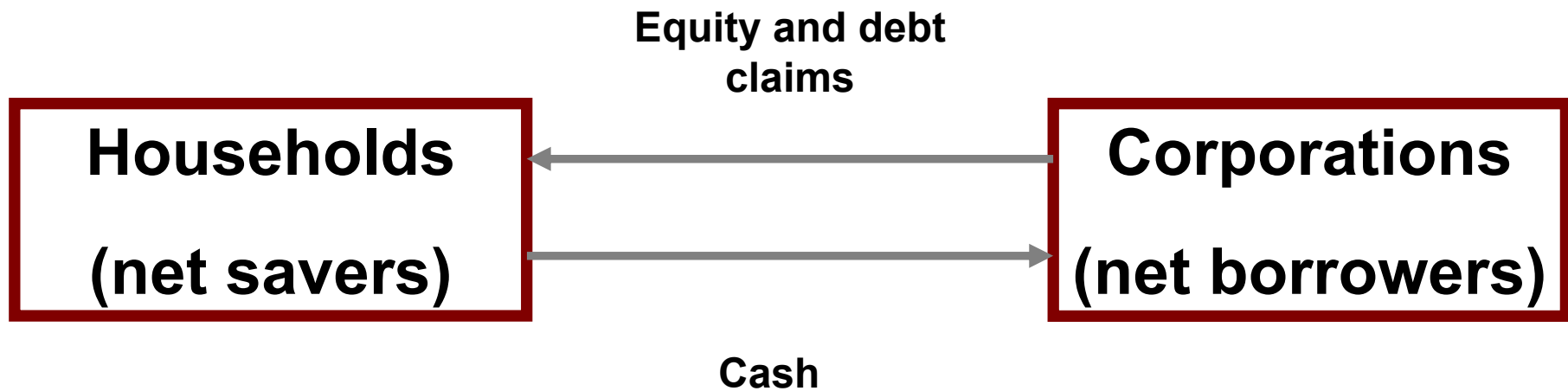
Why Are Financial Institutions Special?



Why Are Financial Intermediaries Special?

- Objectives:
 - Explain the special role of FIs in the financial system and the functions they provide
 - Explain why the various FIs receive special regulatory attention
 - Discuss what makes some FIs more special than others
 - Explain the crisis in financial markets

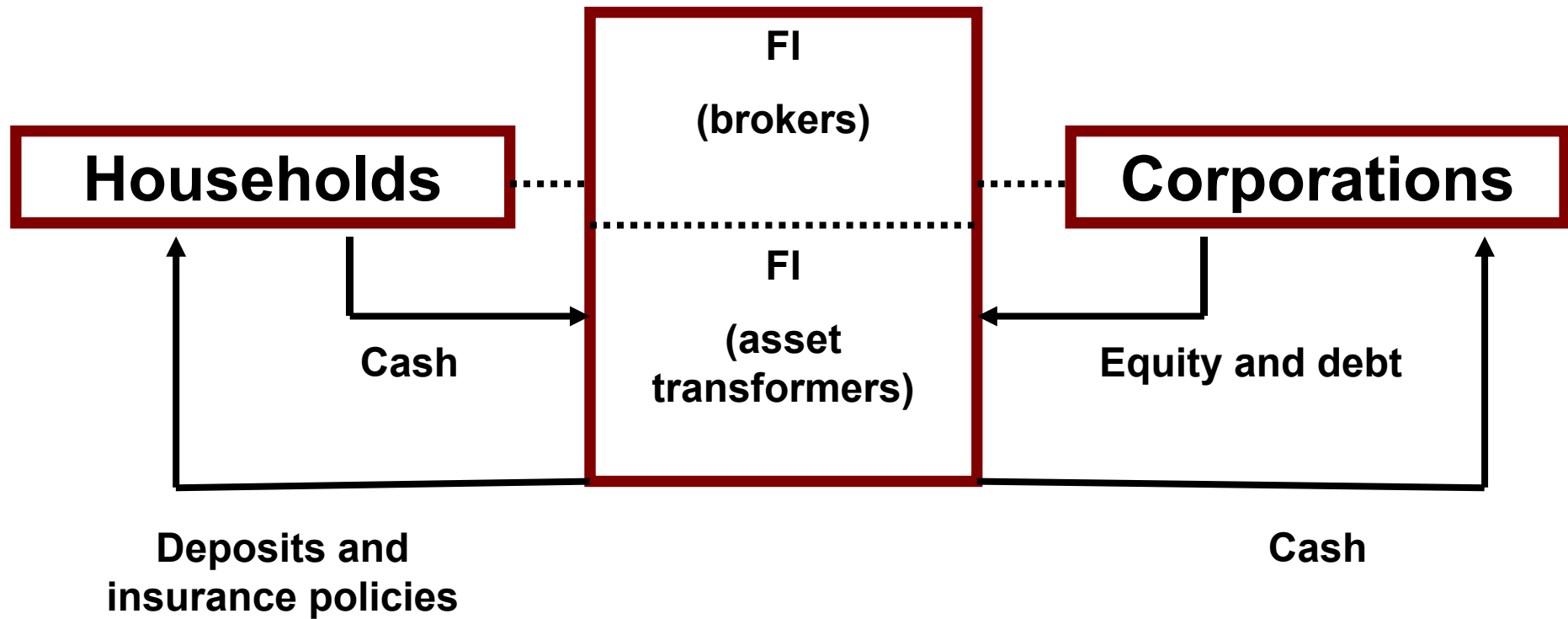
Without FIs



FIs' Specialness

- Without FIs: Low level of funds flow between households and corporations.
 - Monitoring costs
 - ◆ Economies of scale reduce costs for FIs to screen and monitor borrowers
 - Liquidity costs
 - Substantial price risk

With FIs



Functions of FIs

- Brokerage function
 - Acting as an agent for savers:
 - ◆ e.g. Bank of America Merrill Lynch
 - ◆ Reduce transaction and information costs
 - ◆ Encourages higher rate of savings
- Asset-transformation
 - Issue more attractive financial claims to household savers
 - ◆ Finance the purchase of primary securities by selling financial claims to household investors and others

Role of FIs in Cost Reduction

- Information costs:
 - Investors exposed to Agency Costs
 - ◆ Role of FI as Delegated Monitor
 - FI likely to have greater incentive to monitor
 - Economies of scale in obtaining information
 - ◆ FI as an information producer
 - New secondary securities may enable FIs to monitor more effectively (e.g., bank loans)
 - Short-term contracts allow more control and monitoring power for FIs
 - Reduction of information asymmetry

Specialness of FIs

- Liquidity and Price Risk
 - Secondary claims issued by FIs have less price risk
 - Demand deposits and other claims are more liquid
 - ◆ More attractive to small investors
 - FIs have advantage over households in diversifying risks due to size

Other Special Services

- Reduced transactions costs
- Maturity intermediation
- Transmission of monetary policy
- Credit allocation (areas of special need such as home mortgages)
- Intergenerational transfers or time intermediation
- Payment services (FedWire and CHIPS)
- Denomination intermediation

Specialness and Regulation

- FIs receive special regulatory attention

Reasons:

- Negative externalities of FI failure
- Special services provided by FIs
- Institution-specific functions such as money supply transmission (banks), credit allocation (thrifts, farm banks), payment services (banks, thrifts), etc.

Regulation of FIs

- Important features of regulatory policy:
 - Protect ultimate sources and users of savings
 - ◆ Including prevention of unfair practices such as redlining and other discriminatory actions
 - Primary role:
Ensure soundness of the overall system

Safety and Soundness Regulation

- Protect against the risk of FI failure:
 - Diversification of assets
 - ◆ No more than 5 percent of equity to single borrower
 - Minimum capital requirements
 - ◆ TARP and Capital Purchase Program
 - Guaranty funds:
 - ◆ Deposit Insurance Fund (DIF):
 - ◆ Securities Investors Protection Corporation (SIPC)

Safety and Soundness Regulation Continued

- Monitoring and surveillance:
 - ◆ Involves on-site examinations and review of accounting statements
 - ◆ FDIC monitors and regulates DIF participants
 - ◆ Increased regulatory scrutiny following crises
- Regulation is not costless
 - ◆ Net regulatory burden

Web Resources

- For information on regulation of FIs and investment firms visit:

FDIC www.fdic.gov

SIPC www.sipc.org

Federal Reserve

www.federalreserve.gov

Appendix 1B of text

www.mhhe.com/saunders9e

Monetary Policy Regulation

- Banks have role in transmitting monetary policy from the Federal Reserve to the rest of the economy
 - Federal Reserve directly controls *outside money*
 - Bulk of money supply is *inside money* (deposits)
 - May be required to maintain a specified level of cash reserves against deposits

Credit Allocation Regulation

- Supports socially important sectors such as housing and farming
 - Requirements for minimum amounts of assets in a particular sector or maximum interest rates or fees
 - ◆ Qualified Thrift Lender (QTL) test
 - 65 percent of assets in residential mortgages
 - ◆ Usury laws and Regulation Q (abolished)

Consumer Protection Regulation

- Prevent discrimination in lending
 - Community Reinvestment Act (CRA)
 - Home Mortgage Disclosure Act (HMDA)
- Effect on net regulatory burden
 - FFIEC processed info on as many as 9.9 million mortgage transactions in 2014
 - Analysts questioning the net benefit

Consumer Protection Regulation Continued

- Potential extensions of regulations
 - CRA to other FIs such as insurance companies in light of consolidation and trend toward universal banking
- New additions:
 - Consumer Financial Protection Bureau (2010)
 - Credit card reform bill effective 2010

Investor Protection Regulation

- Aimed at protecting investors that use investment banks directly/indirectly
 - Protection against abuses such as insider trading, lack of disclosure, malfeasance, breach of fiduciary responsibilities
 - Key legislation
 - ◆ Securities Acts of 1933, 1934
 - ◆ Investment Company Act of 1940
 - ◆ Wall Street Reform and Consumer Protection Act of 2010

Entry Regulation

- Entry and activities of FIs are regulated
 - Level of entry impediments affects profitability and value of charter
 - Regulations define scope of permitted activities
 - ◆ Financial Services Modernization Act of 1999
 - Affects charter value and size of net regulatory burden

Additional Web Resources

- For more information on regulation of depository institutions visit:

FFIEC www.ffiec.gov

Federal Reserve www.federalreserve.gov

FDIC www.fdic.gov

OCC www.occ.treas.gov

Changing Dynamics of Specialness

- Trends in the United States
 - Decline in share of depository institutions and insurance companies
 - Increases in investment companies
 - May be attributable to net regulatory burden imposed on depository FIs
 - ◆ Financial Services Modernization Act
 - Financial services holding companies

Risk and the Financial Crisis

- Reactions to FSM Act and other factors:
 - Shift from “originate and hold” to “originate and distribute”
 - ◆ Affects incentives to monitor and control risk
 - ◆ Shift to off balance sheet risks
 - ◆ Degraded quality and increased risk
- Housing market bubble
 - Encouraged subprime market and more exotic mortgages

Global Trends

- US FIs facing increased competition from foreign FIs
- Only 1 of the top ten banks is a US bank
- Foreign bank assets in the US typically more than 10 percent
 - As high as 21.9 percent

Largest Banks

Bank Name	Total Assets
Industrial & Commerce Bank of China (China)	\$3,368.2
China Construction Bank (China)	2,736.6
HSBC Holdings (United Kingdom)	2,634.1
Agricultural Bank of China (China)	2,610.6
J.P. Morgan Chase (United States)	2,573.1
BNP Paribas (France)	2,521.6
Bank of China (China)	2,492.5
Mitsubishi UFJ Financial Group (Japan)	2,382.4
Crédit Agricole Groupe (France)	2,139.3
Barclays Bank (United Kingdom)	2,118.4

Enterprise Risk Management

- Recognizes the value in prioritizing and managing the impact of risks on an interrelated portfolio basis
- Recent financial crisis lead to the focus on ERM
 - Prior to the crisis, the focus was on processes and systems
 - After the crisis, attention shifted to building a strong risk culture that is supported by government arrangements

Financial Crisis

- DJIA fell 53.8 percent in less than 1 ½ years as of mid-March 2009
- Record home foreclosures
 - 1 in 45 households in default in late 2008/2009
 - ◆ Translates to 2.8 million properties
- Goldman Sachs and Morgan Stanley
 - Only major survivors of the investment banking industry

Financial Crisis Continued

- AIG bailout by federal government
- Citigroup needed government support
- Chrysler and GM declared bankruptcy in 2009
- Unemployment in excess of 10 percent as of October 2009

Beginning of the Collapse

- Home prices plummeted in 2006-07
 - Mortgage delinquencies rose
 - Foreclosure filings increased 93 percent from July 2006 to July 2007
 - Securitized mortgages led to large financial losses
 - ◆ Subprime mortgages
 - Countrywide Financial bailed out and was eventually acquired by Bank of America

Significant failures and events

- Bear Stearns funds filed for bankruptcy in the fall of 2007
 - Acquired by J.P. Morgan Chase
 - Fed moved beyond lending only to Depository Institutions
- Government seizure of Fannie Mae and Freddie Mac
- Lehman Brothers failure
- Crisis spread worldwide

Rescue Plan

- Federal Reserve and other central banks infused \$180 billion
- \$700 billion Troubled Asset Relief Program (TARP)
- Still struggling in 2009
- \$827 billion stimulus program
 - American Recovery and Reinvestment Act of 2009

Monetary Policy Tools

- Open Market Operations
- The Discount Rate
- Reserve Requirements (Reserve Ratios)

Effects of Monetary Policy

- Effects of Monetary Policy Tools on Various Economic Variables:
 - Expansionary Activities
 - Contractionary Activities

Pertinent Websites

The Banker	<u>www.thebanker.com</u>
Federal Reserve	<u>www.federalreserve.gov</u>
FDIC	<u>www.fdic.gov</u>
FFIEC	<u>www.ffiec.gov</u>
Investment Co. Institute	<u>www.ici.com</u>
OCC	<u>www.occ.treas.gov</u>
SEC	<u>www.sec.gov</u>
SIPC	<u>www.sipc.org</u>
Wall Street Journal	<u>www.wsj.com</u>