Bank Regulation

Bank Regulation in the United States

James R. Barth*,
Triphon Phumiwasana** and
Wenling Lu**

Banks in countries around the world importantly contribute to economic growth and development. They do so by contributing to a country's payments mechanism and credit system. For this reason banks are among the most regulated firms in countries everywhere. This certainly is the case for banks in the United States. Yet, the US subprime mortgage market meltdown and the associated credit crunch that emerged in 2007 underscored the need to reform the current regulatory structure. President Bush signed into law the Housing and Economic Recovery Act in July 2008, mainly to provide relief to homeowners facing foreclosure and thereby lessen downward pressure on home prices and limit the curtailment of credit. However, this Act alone is not enough to promote a more efficient, stable and competitive banking industry. Given these developments, it is an opportune time to examine the current US regulatory structure and to discuss ways in which it could be reformed to be more efficient and more appropriate for today's banking industry.

How we got to where we are

The current bank regulatory structure is outlined in Figure 1. It is clear that there are multiple and overlapping regulatory authorities that contribute to inconsistent and costly regulation. The lack of a comprehensive design is due to the fact that, as Figure 2 shows, the regulatory structure is the outcome of a series of piecemeal actions taken in response to discrete events over the past two centuries. It is therefore essential to note the more important developments to understand how the US got to where it is today.

Bank regulation developed in a unique fashion because the US started as a confederation of constituent states. This led to a dual regulatory system in which both the states and the federal government charter and regulate banks. Conflicts led to this situation being suspended for a short period of time, however. In 1791 the US Congress chartered a federal bank for twenty years to act as a central bank and then did the same thing again in 1816, but state opposition each time led to the charters not being renewed (Spong 1994, 15). This took the federal government completely out of the bank chartering and regulation business until the US Office of the Comptroller of Currency (OCC) was established in 1863 to charter and regulate national banks.

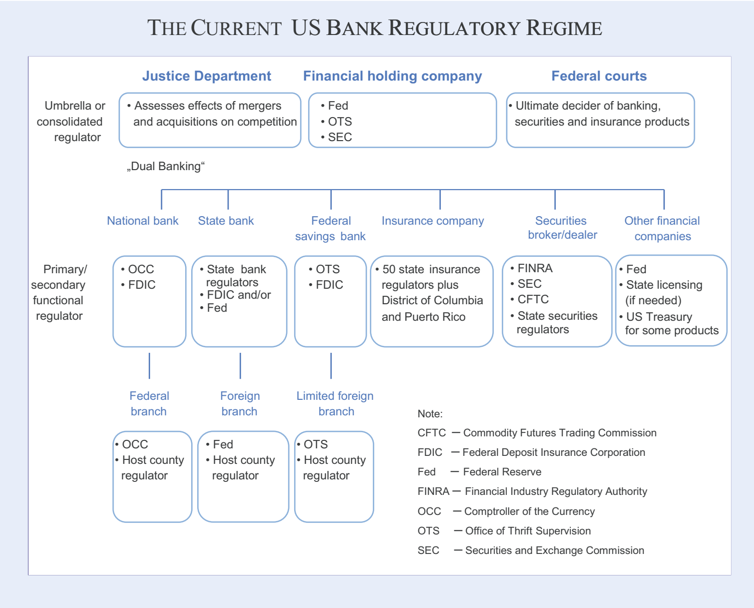
Since commercial banks did not seek smaller depositors and provide mortgages in their early years, mutual savings banks were established in 1816 and savings and loans (S&Ls) in 1831 to provide each of these services, respectively. Lastly, credit unions were established in 1909 to provide basic financial services, but only to qualifying members. These are the four types of depositories that still exist in the US today.

After the Civil War, the US suffered several banking panics that led to the establishment of the Federal Reserve System (Fed) in 1913 to provide liquidity to the financial sector. It also has regulatory authority over some banks.

During the Great Depression, the Federal Deposit Insurance Corporation (FDIC) was established to convince depositors that their funds were always safe, and thereby prevent "runs" on banks. These occurred when large numbers of depositors thought their banks were in trouble. They would rush to withdrawal deposits and thereby drive even sound banks into insolvency by being forced to sell assets at depressed prices. Also, the National Banking Act of 1933, or Glass-Steagall Act, was enacted to sepa-

* Auburn University and Milken Institute.
** Milken Institute.

Figure 1



rate commercial banking from investment banking to minimize conflicts of interest that might arise between the two activities. At the same time, the Securities and Exchange Commission (SEC) was established to promote the disclosure of all material information to potential investors when firms seek to raise funds from the public. To accomplish this task it was given regulatory authority over investment banks.

After bank holding companies came into existence, the Bank Holding Company Acts of 1956 and 1970 were enacted to restrict the non-banking activities of corporations controlling one or more banks. The Fed was given responsibility for regulating such corporations (BHCs) and for determining which non-banking activities are allowed.[1]

In response to the S&L crisis that began in 1980, the US Congress passed the Depository Institutions Deregulation and Monetary Control Act the same year and the Garn-St Germain Act in 1982. These two laws expanded the powers of savings and loans, mutual savings banks and credit unions, and thereby blurred the historical distinctions that had existed among them. The motivation for the laws was the belief that if these institutions became more like banks that had largely avoided the S&L crisis, future problems would be prevented. But in so doing the rationale for maintaining separate regulatory authorities for the different types of depository institutions was undermined.

Laws were subsequently enacted to reduce the restrictions on the location of a bank's offices. Each state specifies its own branching restrictions for banks. However, when first established, national banks were not allowed to have any branches. The McFadden Act of 1927 changed this by allowing a national bank to follow the branching rules of the state in which it is located, though prohibiting branching across state lines. The Bank Holding Company Act of 1956 prohibited BHCs from circumventing interstate restrictions through acquisitions across state boundaries.

Then, in 1994, the Riegle-Neal Interstate Banking and Branching Efficiency Act ("Riegle-Neal") repealed the McFadden Act and allowed BHCs to acquire a bank in any state.[2] Furthermore, beginning on 1 June 1997, a BHC was free to consolidate its interstate banks into a branch network, and banks were allowed to branch across state lines through acquisitions and turning the acquired bank into a branch. *De novo* branching was also permissible, provided state law authorized it.

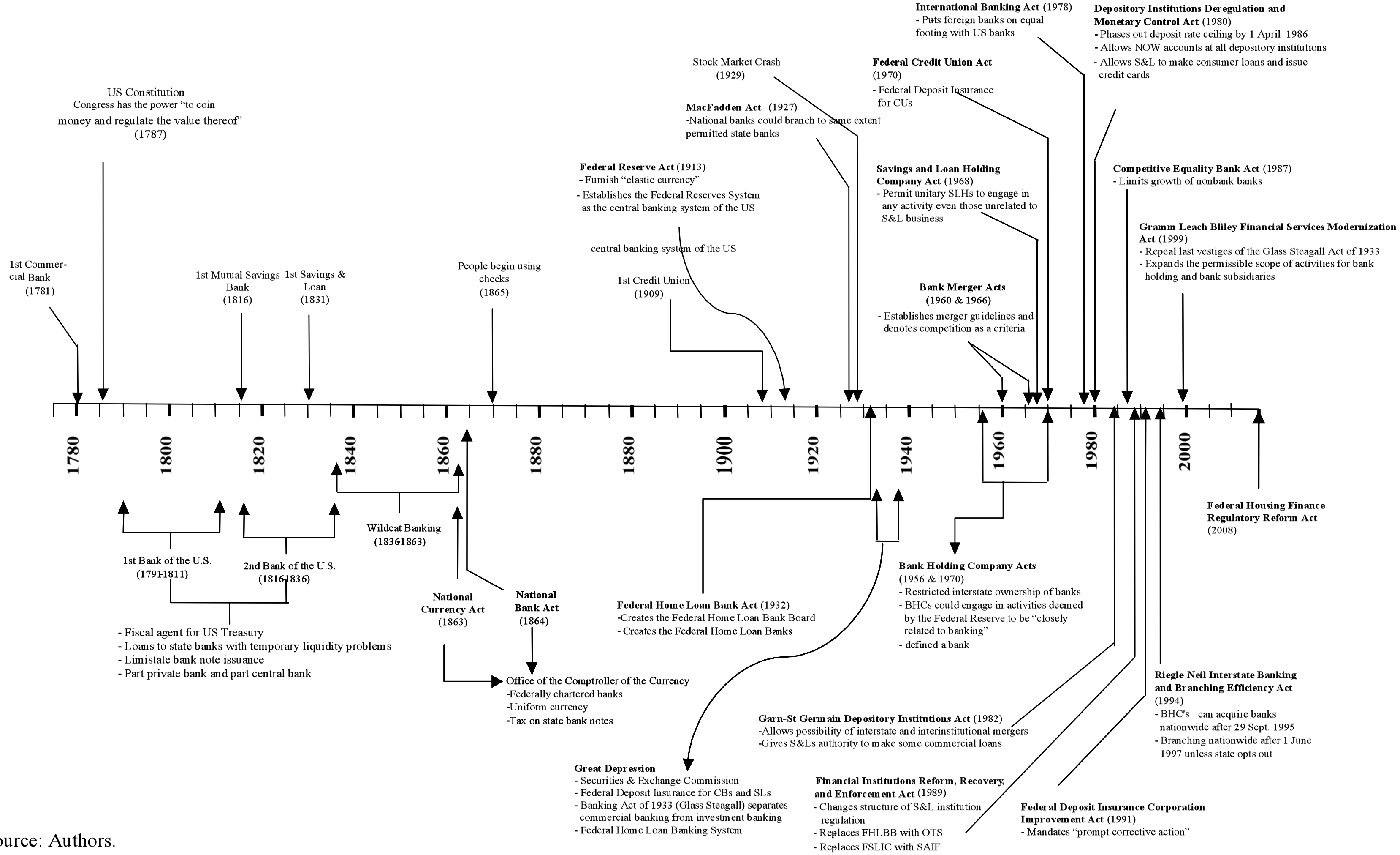
Like Riegle-Neal, the Gramm-Leach-Bliley Act (GLBA) of 1999 was also a struggle to counter restrictive laws. It repealed significant parts of the Glass-Steagall Act separating commercial banking from the securities business, as well as parts of the Bank Holding Company Act of 1956 separating commercial banking from the insurance business (Barth, Brumbaugh and Wilcox 2000). Thus, GLBA permits a financial services holding company to offer banking, securities and insurance, but the mixing of banking and commerce is strictly prohibited.

[1] To promote a level playing field, the International Banking Act of 1978 (IBA) was adopted so that foreign banks would be treated the same as domestic banks, so-called national treatment.

[2] The conditions are as follows: 1) the bank holding company (BHC) must be adequately capitalized and adequately managed; 2) the BHC's community reinvestment record must pass a review by the Federal Reserve Board; 3) the acquisition must not leave the acquiring company in control of more than 10 percent of nationwide deposits or 30 percent of deposits in the state; and 4) the bank to be acquired must meet any age requirement (i.e., in terms of years in existence), up to five years, established under state law.

Figure 2

HISTORICAL PERSPECTIVE ON US BANKING STRUCTURE AND REGULATION



Source: Authors.

The subprime mortgage market meltdown results in still more changes

The "subprime mortgage market crisis" began in early 2007 as foreclosure rates on newly originated mortgages rose rapidly and several subprime lenders declared bankruptcy. Things worsened in the summer of 2007 when two Bear Stearns' hedge funds, heavily invested in securities tied to mortgages, collapsed. Furthermore, declining home prices, rising foreclosures, and increasing credit losses led to a credit crunch. Tallying up the results through 4 August 2008, the US subprime home mortgage market was at the epicenter of a crisis that had resulted in $483 billion in losses/write downs at banks and other financial firms and $353 billion in capital raised from new and existing shareholders (Barth, Li, Phumiwasana and Yago 2008).

In response to this troubling situation, President Bush pushed for a voluntary freeze on interest rates in December 2007 for a select group of roughly 600,000 borrowers with subprime mortgages in an effort to prevent foreclosures. Then, in February 2008, he signed into law the Economic Stimulus Act that provided tax rebates to taxpayers, tax incentives to stimulate business investment and an increase in the limits imposed on mortgages eligible for purchase by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). The Housing and Economic Recovery Act was then enacted in July 2008 authorizing the Federal Housing Authority (FHA) to guarantee up to $300 billion in new 30-year fixed rate mortgages for subprime borrowers if lenders voluntarily write down principal loan balances to 90 percent of current appraisal value. The Act also established a single regulator – the Federal Housing Finance Agency – for Fannie Mae, Freddie Mac and the Federal Home Loan Banks and provides temporary authority to the Secretary of the Treasury to lend to or purchase stock in Fannie Mae or Freddie Mac in any amount deemed necessary to prevent their insolvency.

It is essential to understand some of the important changes that have taken place in US mortgage markets over the past three decades and how they have contributed to this dire situation. Prior to 1980, the vast majority of all home mortgage loans were made by savings and loans. These institutions originated, serviced (i.e., collecting principal and interest payments), and held these loans in portfolios. As early as 1970, however, the combining of these three functions within a single institution began to change, as home mortgage loans were increasingly securitized by the Government National Mortgage Association (Ginnie Mae), Fannie Mae, and Freddie Mac. Indeed, these three agencies securitized only 1 percent of all outstanding mortgages in 1965, but nearly 50 percent in 2008.

Securitization contributed to the unbundling of the home mortgage process insofar as savings and loans no longer had to hold these mortgages in their portfolios. Investors in the securities backed by home mortgages also provided an additional source of funding beyond the deposits of savings and loans. The origination and servicing of mortgages also became separate functions not entirely performed by savings and loans. The unbundling of the home mortgage process into these three separate functions (funding, origination and servicing) meant there were also three separate sources of revenue, with only those providing funding (i.e., lenders or investors in mortgage-backed securities) for home mortgage loans bearing any credit risk.

The financial innovations of securitization and adjustable-rate mortgages contributed to the modernization of the US mortgage markets by providing more diverse sources of funding for home mortgages and a wider choice of mortgage products for consumers. Increased use of adjustable-rate mortgages also allowed the sharing of interest risk by both lenders and borrowers. Those individuals choosing adjustable-rate mortgages typically receive an initial interest rate lower than one for a fixed-rate mortgage, but then face the prospect of higher rates if market interest rates rise. The development and wide use of credit scores for individual borrowers and credit ratings for individual issuances of mortgage-backed securities, moreover, is supposed to provide more information for lenders, borrowers and investors to better assess and price risk.

In recent years, subprime home mortgage loans grew rapidly. Indeed, the subprime share of total originations was less than 5 percent in 1994, increased to 13 percent in 2000, and then further grew to more than 20 percent in both 2005 and 2006 before declining to 7.9 percent in 2007 as the crisis unfolded. Furthermore, the share of subprime originations packaged into mortgage-backed securities more than doubled over the same seven-year period, from 31.6 percent to 80.5 percent. Securitization of home mortgage loans, moreover, was no longer overwhelmingly dominated by Ginnie Mae, Fannie Mae, and Freddie Mac. Home mortgage loans securitized by non-agency entities grew rapidly from $386 billion in 2000 to $2.1 trillion in 2007.

In 2007, as noted earlier, substantial problems began to emerge in the subprime loan market when several subprime mortgage lenders filed for bankruptcy and other financial firms suffered heavy losses on subprime securities, and credit and liquidity problems spread throughout the financial sector. The majority of these losses were triggered by the increasing rate of foreclosures on subprime loans from 2000 to March 2008. Indeed, more than half of all the nearly 1 million homes in foreclosure at year-end 2007, moreover, involved subprime loans. More generally, FitchResearch (2008) estimates that the total market loss of the subprime mortgage crisis will be $400 billion to $550 billion (by comparison, the savings and loan crisis cost $408 billion in 2007 dollars, of which 82 percent was borne by taxpayers). This troublesome situation has led to many condemnations of subprime mortgage loans and securitization.

Instead of criticizing the use of subprime mortgage loans, actions should focus on better educating consumers on complex loan products and simplifying the documents necessary for informed decision-making. After all, consumers must be allowed to choose mortgage products, even if some expose borrowers to interest-rate risk. Also, there should be greater transparency for loans made on the basis of less stringent origination practices, such as making loans on the basis of no down payments and stated rather than verified income, so that investors in such loans or securities backed by them have better knowledge about the risk-return tradeoffs of alternative investments. In addition, investors in mortgage-backed securities ultimately must engage in their own due diligence rather than solely relying on rating agencies to assess the quality of the underlying collateral. Furthermore, and most importantly, the regulatory authorities have a responsibility to take more timely and cost-effective actions in response to a developing crisis, rather than acting after a crisis is apparent to everyone, which all too frequently is the case.

Still further reform is needed

Further bank regulatory reform is surely needed as Treasury Secretary Paulson indicated in March 2008 with the issuance of the *Blueprint for A Modernized Financial Regulatory Structure.* The Treasury proposal consists of two parts: short-term and intermediate-term recommendations. The short-term recommendations include the following:

- Expanding the president's working group (PWG) on financial markets to promote greater coordination and communication in four distinct areas:
  - Mitigating systemic risk to the financial system,
  - Enhancing financial market integrity,
  - Promoting consumer and investor protection,
  - and supporting capital markets efficiency and competitiveness.
- Addressing the mortgage origination problems by:
  - Establishing a new federal commission, the Mortgage Origination Commission (MOC).
  - Enacting federal legislation to set forth (or provide authority to the MOC to develop) uniform minimum licensing qualification standards for state mortgage market participants. These should include personal conduct and disciplinary history, minimum educational requirements, testing criteria and procedures, and appropriate license revocation standards. The MOC would also evaluate, rate, and report on the adequacy of each state's system for licensing and regulation of participants in the mortgage origination process.
- Improving the liquidity provisioning by the Fed:
  - The current temporary liquidity provisioning process during those rare circumstances when market stability is threatened should be enhanced to ensure that: the process is calibrated and transparent; appropriate conditions are attached to lending; and information flows to the Fed through on-site examination or other means as determined by the Fed are adequate.
  - Second, the PWG should consider broader regulatory issues associated with providing discount window access to non-depository institutions.

The intermediate-term recommendations include the following:

- Phasing out and transitioning the federal savings and loan and mutual savings bank charters to the national bank charter.
- Allowing for federal supervision of state-chartered banks by placing all banking examination responsibilities for state chartered banks with federal deposit insurance with the Fed and/or FDIC.

- Allowing the Fed the oversight responsibilities for payment and settlement systems. They should have discretion to designate a payment and settlement system as systemically important and a full range of authority to establish regulatory standards.
- Recommendation for establishing an optional federal charter for insurers within the current structure. This would provide for a system of federal chartering, licensing, regulation and supervision for insurers, reinsurers and insurance producers (i.e., agents and brokers). And Treasury recommends that Congress establish an Office of Insurance Oversight within Treasury to address international regulatory issues, such as reinsurance collateral and advise the Secretary of the Treasury on major domestic and international policy issues.
- Product and market participant convergence, market linkages and globalization have rendered regulatory bifurcation of the futures and securities markets untenable, potentially harmful and inefficient. The Commodity Futures Trading Commission and the SEC should be merged to provide unified oversight and regulation of the futures and securities industries.

Although the Treasury proposal has not received the attention it deserves and most certainly will not be acted upon before a new president takes off in early 2009, it does at the very least identify some of the reforms that need to be carefully considered in a much needed debate to determine the most efficient and appropriate regulation for banks operating and competing in today's domestic and global environment. Clearly, the complex regulatory structure that currently exists may give the false impression to too many individuals that crises will not occur. But even if this is not the case, the all too frequent bail-outs that occur after crises and the re-enforcing effect this has on the belief that this practice will continue into the future create moral hazard and undermine market discipline (Barth, Caprio and Levine 2006).

References

Barth, J. R., C. Li, T. Phumiwasana and G. Yago (2008), "Perspectives on the Subprime Mortgage Market", Milken Institute Policy Brief.

Barth, J. R., L. Goldberg, D. E. Nolle and G. Yago (2006), "Financial Supervision and Crisis Management: U.S. Experience and Lessons for Emerging Market Economies", in L.-J. Cho and J.-K. Kim, eds., *Regulatory Reforms in the Age of Financial Consolidation: Emerging Market Economy and Advanced Countries,* Korea Development Institute and East-West Center.

Barth, J. R. (1991), *The Great Savings and Loan Debacle,* The AEI Press, Washington DC.

Barth, J. R., G. Caprio, Jr. and R. Levine (2006), *Rethinking Bank Regulation: Till Angels Govern,* Cambridge University Press, Cambridge.

Barth, J. R., R. D. Brumbaugh and J. A. Wilcox (2000), "The Repeal of Glass-Steagall and the Advent of Broad Banking," *Journal of Economic Perspectives* 14(2), 191–204.

Board of Governors of the Federal Reserve System and U.S. Department of the Treasury (2003), *Report to the Congress on Financial Holding Companies under the Gramm-Leach-Bliley Act.*

FitchResearch, "Subprime Mortgage-Related Losses", May 14, 2008.

U.S. Treasury (2008), *Blueprint for A Modernized Financial Regulatory Structure,* Washington, DC. http://www.treas.gov/press/releases/reports/Blueprint.pdf.