

SOLUTIONS MANUAL

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Bank Management



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Chapter 2

Government Policies and Regulation

Chapter Objectives

1. Describe the regulatory environment in which financial services companies compete.
2. Describe the goals and functions of depository institutions.
3. Evaluate how the regulation of depository institutions impacts their safety and soundness .
4. Outline how the Federal Reserve maintains monetary stability.
5. Examine how regulation of financial institutions impacts the efficiency and competitiveness of the financial system.

Key Concepts

1. Historically, commercial banks have been regulated more than firms in any other industry. The close supervision by regulators follows from the use of deposit insurance whereby for qualifying deposits, the owners' funds are insured by the Federal Deposit Insurance Corporation. Any failure required that the owner receive the full amount of the insured deposit.
2. The primary objectives of regulation are to:
 - a. Ensure the safety and soundness of the financial system
 - b. Provide an efficient and competitive financial system
 - c. Maintain monetary stability and the integrity of the payments system
 - d. Protect consumers of financial services from abuses
3. The supervision of financial institutions (both depository and non-depository) is done by a variety of entities, including the Federal Reserve, the FDIC, the OCC, the OTS, the NCUA, and the various state banking boards. Responsibility for oversight often overlaps across the various agencies.
4. The limit federal deposit insurance has been increased to \$250,000 per depositor through the end of 2013. Because of the increase in bank failures, the Deposit Insurance Fund is below its goal of 1.25% of deposits.
5. Depository financial institutions are highly regulated in the products and services they can offer. Some of the allowed activities include:
 - Branching
 - Consulting and financial advice
 - Corporate governance
 - Correspondent service
 - Finder activities
 - Leasing
 - Lending
 - Payment services
 - General trust activities, employee benefit accounts, and real estate brokerage
 - Insurance and annuities activities
 - Securities activities

- Electronic bill payments
 - Electronic storage and safekeeping
 - Internet and PC banking
6. Regulation cannot eliminate risk and does not prevent bank failure. It cannot guarantee that bank management will make good decisions. Regulation can enhance safety, but also hinders competition.
 7. The Federal Reserve has three main tools for implementing monetary policy:
 - Open Market Operations
 - Discount Rate
 - Reserve Requirements
 8. Some unresolved regulatory issues involve:
 - Capital Adequacy
 - Regulatory Reform
 - Disparate regulations for depository versus non-depository institutions

Teaching Suggestions

This chapter represents an opportunity to link bank management topics to the current regulatory environment. As a semester project, students should be encouraged to keep a file or log of events from recent newspapers or magazines that demonstrate the impact of the new regulations. Regular reference to *The Wall Street Journal* contributes to student understanding and interest.

Sample Projects and Assignments

1. Have students critique the data in Exhibit 2.6 regarding the number of institutions by type, asset size and growth rates since 1970. What are the key implications? They should then compare these figures with those in Exhibit 2.7 and explain how other financial services companies appear to be capturing far greater market share over time.
2. Have students list and critique the actions taken by the Federal Reserve and U.S. Treasury in response to the financial crisis of 2007 - 2009.

Answers to End-of-Chapter Questions

1. Many bank customers value convenience in addition to the range of services and pricing. Banks that have many branches offer greater convenience. It is easier to make deposits, withdraw funds, visit with customer service representatives, etc. if your bank has an office near where you live and/or work. A bank with just one main office foregoes these benefits. The primary disadvantage is cost. Many branches are expensive to build and the building is a non-earning asset.
2. Bank regulation is too complex today with overlapping responsibilities among the regulatory agencies. The situation largely reflects the chartering system, state versus federal competition among regulators, and the existence of FDIC insurance. Many politicians and business people want local representatives to govern banks – hence, the appeal of state banking departments. Some individuals prefer the enforcement of national standards. We also have historically had different rules for different size institutions. Over time U.S. institutions have

experienced financial difficulties and the federal government has had to pay insured depositors upon failure of a bank. Taxpayers and federal officials want to control the examination and regulation of insured banks. It is not uncommon today to have several regulatory groups (Federal Reserve, FDIC, OCC, state banking departments) examine the same institution. It would be best to streamline regulation and examinations by conducting them jointly, where possible. The U.S. should also consolidate duties among the different regulatory groups and eliminate duplicate services.

3. The objectives of depository institution regulation are:
 - a. Ensure the safety and soundness of the financial system
 - b. Provide an efficient and competitive financial system
 - c. Maintain monetary stability and the integrity of the payments system
 - d. Protect consumers of financial services from abuses

4. Regulation is not intended to prevent failures. The objectives are to:
 - a. Ensure the safety and soundness of the financial system
 - b. Provide an efficient and competitive financial system
 - c. Maintain monetary stability and the integrity of the payments system
 - d. Protect consumers of financial services from abuses

5. At the same time that Congress increased the insured deposit amount to \$100,000, it expanded the range of services and lines of business that commercial banks and thrifts could offer. Many institutions grew their deposits at unmanageable rates by simply buying funds through brokerage houses. As such, they would authorize a broker to pay whatever rate was necessary to sell large amounts of fully-insured deposits to customers. The institutions then speculated with the funds. If the investments (gamble) paid off, the institution received the benefit. If the investments didn't pay, the FDIC often had to close the banks and pay insured depositors upon the failure. The latter occurred frequently during the 1980s and early 1990s. Raising deposit insurance amounts made it much easier to quickly grow a bank. With the recent increase in coverage to \$250,000 per depositor, banks will be able to continue to grow with insured deposits.

6. CAMELS is an acronym that indicates the categories in which banks are examined. Regulators formally assign scores (1 to 5 where 5 is bad) to a bank's:

C = Capital Adequacy
A = Asset Quality
M = Management Quality/Performance
E = Earnings Quality
L = Liquidity
S = Sensitivity to Market Risk

Most bank failures reflect poor asset quality (bad loans). Bad loans may arise from poor loan underwriting, inadequate policies and lending practices, etc. The most important facets of an examination are to evaluate whether the bank has the appropriate policies, practices and procedures in place and whether asset quality is sufficiently strong.

7. In the 1930s, Congress separated commercial banking activities (such as accepting deposits and making loans) from investment banking activities (such as underwriting securities) so that the same bank wouldn't tie the availability of credit (a loan) to a firm's willingness to have the bank provide investment banking services. U.S. banks were eventually allowed to underwrite securities outside the U.S. via regulatory fiat as a benefit to large banks to help

them compete with foreign institutions that didn't face the same restrictions on their lending or underwriting activities. If U.S institutions meet specific criteria, they can underwrite securities anywhere today.

8. Banks that have strong senior management, a well-trained staff, large amounts of capital, and good market share are best positioned to benefit from increased competition. They can choose the lines of business to enter and exit, have access to capital, and can expand geographically where appropriate. Strong management is evidenced by a constant reevaluation of strategies necessary to compete and the ability to implement the strategies. A bank's Board of Directors should play a key role in ensuring the viable operation of the firm and continual strategic planning.
9. Gramm-Leach-Bliley (1999) effectively allowed banks to offer services in a wide range of areas and to enter new lines of business. It similarly allowed other financial services companies to offer traditional commercial banking products and services. The largest institutions with the greatest amounts of capital have generally been aggressive in expanding geographically and across lines of business. Smaller institutions do not have the same access to capital, but can selectively enter new markets and offer a wider range of financial services. The number of small banks changes with new charters and acquisitions/mergers. GLB might hasten the acquisitions of small banks as some owners/managers will choose to sell rather than compete and the range of buyers is now greater. Many believe that it was the expansion into new products that led to the financial crisis of 2007-2009. With banks getting away from their core competencies, they got into areas that they did not fully understand.
10. Banks are losing market share due to increased competition. Many entities now make loans and accept deposits which represent the core bank products. Many of these competitors target large firms with the largest loans and deposits. Many banks have similarly decided not to take as much credit risk. As such, they originate loans then securitize them. Securitization effectively moves the loans off bank balance sheets. Market share data that reflect assets will understate the role of banks. Banks would have to hold more assets on balance sheet and have access to greater sources of funding for the market share data to increase. One should examine revenue for an alternative view. Clearly, mutual funds and pension plans are increasing their holdings of financial assets because that is the very nature of their businesses. They collect funds - many customers view pension contributions as a critical savings vehicle and mutual funds offer attractive alternatives to bank deposits – such that the data reflect their growth over time. As a result of the financial crisis of 2007-2009, this loss of market share may reverse as non-depository financial institutions become more heavily regulated.
11. Increased capital at a bank lowers risk. This potentially benefits depositors by reducing the likelihood of failure and deposit runs. Equity owners gain because their investment is safer, and recently the stock market has attached a premium to banks with substantial equity because they are perceived to be safer with greater expansion opportunities. Society generally benefits because safe banks are more likely to lend. Additional capital should be required as banks and other firms offer nontraditional products. It is not appropriate for the FDIC to insure other lines of business or products because firms should only offer them if they are willing to accept and able to manage the risk. Firms should be allowed to fail when they operate poorly. One way to require capital would be to estimate the riskiness of the line of business relative to other activities of the firm. The greater is perceived risk, the greater should be the capital requirements. Perhaps capital requirements should be linked to the volatility in returns of the line of business.
12. A small community bank cannot earn above-average returns on these low-margin products/services today because of competition. It must develop other loan products or services that can be offered at profitable margins. This might be some specialized form of lending tied to a specific type of loan or industry, it might be emphasizing originating loans and selling them to long-term investors, while retaining servicing, or it might be offering non-credit products that competitors don't successfully offer within their trade area. Management might also focus on

how these services are delivered. Many start-up operations in today's environment invest little in offices and branches and offer the bulk of their services over the internet, via telephone, or via banking representatives going to the customers' places of businesses with their laptops. This potentially controls costs and allows greater room for competitive investments.