13.5: Bank Regulation

Learning Objectives

- Explain bank supervision and measures taken to reduce the risk of bank insolvency (including reserve requirements, bank capital requirements, and restrictions on investments)
- Explain how deposit insurance and lender of last resort are two strategies to protect against bank runs

A safe and stable national financial system is a critical concern of the Federal Reserve. The goal is not only to protect individuals' savings, but to protect the integrity of the financial system itself. This esoteric task is usually behind the scenes, but came into view during the 2008–2009 financial crisis, when for a brief period of time, critical parts of the financial system failed and firms became unable to obtain financing for ordinary parts of their business. Imagine if suddenly you were unable to access the money in your bank accounts because your checks were not accepted for payment and your debit cards were declined. This gives an idea of a failure of the payments/financial system.

Bank regulation is intended to maintain banks' solvency by avoiding excessive risk. Regulation falls into a number of categories, including reserve requirements, **capital requirements**, and restrictions on the types of investments banks may make. In the previous module on money and the banking system, we learned that banks are required to hold a minimum percentage of their deposits on hand as reserves, to cover desired withdrawals by depositors. "On hand" is a bit of a misnomer because, while a portion of bank reserves are held as cash in the bank, the majority are held in the bank's account at the Federal Reserve.

Bank capital is the difference between the value of a bank's assets and the value of its liabilities. In other words, it is a bank's net worth. A bank must have positive net worth; otherwise it is insolvent or bankrupt, meaning it would not have enough assets to pay back its liabilities. Regulation requires that banks maintain a minimum net worth, usually expressed as a percent of their assets, to protect their depositors and other creditors.

Another part of bank regulation is restrictions on the types of investments banks are allowed to make. Banks are permitted to make loans to businesses, individuals, and other banks. They can purchase U.S. Treasury securities but, to protect depositors, they are not permitted to invest in the stock market or other assets that are perceived as too risky.

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Bank Supervision

Several government agencies monitor banks' balance sheets to make sure they have positive net worth and are not taking too high a level of risk. Within the U.S. Department of the Treasury, the Office of the Comptroller of the Currency has a national staff of bank examiners who conduct on-site reviews of the 1,500 or so of the largest national banks. The bank examiners also review any foreign banks that have branches in the United States. The Office of the Comptroller of the Currency also monitors and regulates about 800 savings and loan institutions.

The National Credit Union Administration (NCUA) supervises credit unions, which are nonprofit banks that their members run and own. There are over 6,000 credit unions in the U.S. economy, although the typical credit union is small compared to most banks.

The Federal Reserve also has some responsibility for supervising financial institutions. For example, conglomerate firms that own banks and other businesses are called bank holding companies. While other regulators like the Office of the Comptroller of the Currency supervises the banks, the Federal Reserve supervises the holding companies.

When bank supervision (and supervision of bank-like institutions such as savings and loans and credit unions) works well, most banks will remain financially healthy most of the time. If the bank supervisors find that a bank has low or negative net worth, or is making too high a proportion of risky loans, they can require that the bank change its behavior—or, in extreme cases, even force the bank to close or be sold to a financially healthy bank.

Bank supervision can run into both practical and political questions. The practical question is that measuring the value of a bank's assets is not always straightforward. A bank's principal assets are its loans, and the value of these assets depends on the risk that customers will not repay these loans on time, or at all. These issues can become even more complex when a bank makes loans to banks or firms in other countries, or arranges financial deals that are much more complex than a basic loan.

The political question arises because a bank supervisor's decision to require a bank to close or to change its financial investments is often controversial, and the bank supervisor often comes under political pressure from the bank's owners and the local politicians to keep quiet and back off.

For example, many observers have pointed out that Japan's banks were in deep financial trouble through most of the 1990s; however, nothing substantial had been done about it by the early 2000s. A similar unwillingness to confront problems with struggling banks is visible across the rest of the world, in East Asia, Latin America, Eastern Europe, Russia, and elsewhere.

In the United States, the government passed laws in the 1990s requiring that bank supervisors make their findings open and public, and that they act as soon as they identify a problem. However, as many U.S. banks were staggered by the 2008-2009 recession, critics of the bank regulators asked pointed questions about why the regulators had not foreseen the banks' financial shakiness earlier, before such large losses had a chance to accumulate.

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Deposit Insurance

The risk of bank runs creates instability in the banking system. Even a rumor that a bank might experience negative net worth could trigger a bank run and, in a bank run, even healthy banks could be destroyed. Moreover, a run at one bank often triggered financial contagion that threatens the integrity of the payment system across the economy.

To protect against bank runs, Congress has put two strategies into place: deposit insurance and the lender of last resort. **Deposit insurance** is an insurance system that makes sure depositors in a bank do not lose their money, even if the bank goes bankrupt. About 70 countries around the world, including all of the major economies, have deposit insurance programs. In the United States, the Federal Deposit Insurance Corporation (FDIC) is responsible for deposit insurance. Banks pay an insurance premium to the FDIC. The insurance premium is based on the bank's level of deposits, and then adjusted according to the riskiness of a bank's financial situation. In 2009, for example, a fairly safe bank with a high net worth might have paid 10–20 cents in insurance premiums for every $100 in bank deposits, while a risky bank with very low net worth might have paid 50–60 cents for every $100 in bank deposits.

Bank examiners from the FDIC evaluate the banks' balance sheets, looking at the asset and liability values to determine the risk level. The FDIC provides deposit insurance for about 5,898 banks (as of the end of February 2017). Even if a bank fails, the government guarantees that depositors will receive up to $250,000 of their money in each account, which is enough for almost all individuals, although not sufficient for many businesses. Since the United States enacted deposit insurance in the 1930s, no one has lost any of their federally insured deposits. Bank runs no longer happen at insured banks.

Private deposit insurance programs have been shown to be unable to handle systemic bank runs when too many banks fail. Only the Federal government has the resources to cover large amounts of deposit losses.

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Lender of Last Resort

The problem with bank runs is not that insolvent banks will fail; they are, after all, bankrupt and need to be shut down. The problem is that bank runs can cause solvent banks to fail and spread to the rest of the financial system. To prevent this, the Fed stands ready to lend to banks and other financial institutions when they cannot obtain funds from anywhere else. This is known as the **lender of last resort** role. For banks, the central bank acting as a lender of last resort helps to reinforce the effect of deposit insurance and to reassure bank customers that they will not lose their money.

The lender of last resort task can arise in other financial crises, as well. During the 1987 stock market crash panic, when U.S. stock values fell by 25% in a single day, the Federal Reserve made a number of short-term emergency loans so that the financial system could keep functioning. During the 2008-2009 recession, we can interpret the Fed's "quantitative easing" policies (explained in more detail later) as a willingness to make short-term credit available as needed in a time when the banking and financial system was under stress.

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Watch It

Watch this video to better understand how and why the Fed serves as a lender of last resort. The video also explains why the government bailed banks out of the 2008 financial crisis.

An interactive or media element has been excluded from this version of the text. You can view it online here: http://pb.libretexts.org/mlum/?p=555

glossary

[glossary-page][glossary-term]bank capital requirements minimum percentage (of assets):[/glossary-term]
[glossary-definition] a bank’s capital must exceed to stay in operation[/glossary-definition][glossary-term]bank run:[/glossary-term]
[glossary-definition]when depositors fear their bank is insolvent, they will “run” to withdrawn their deposits; because of fractional reserve banking, bank runs can turn solvent banks insolvent[/glossary-definition][glossary-term]deposit insurance:[/glossary-term]
[glossary-definition]program which insures commercial bank depositors up to $250,000 per bank in the U.S.[/glossary-definition]
[glossary-term]lender of last resort:[/glossary-term]
[glossary-definition]role of the Fed to provide loans to distressed banks when the banks can’t obtain credit from anywhere else[/glossary-definition][/glossary-page]