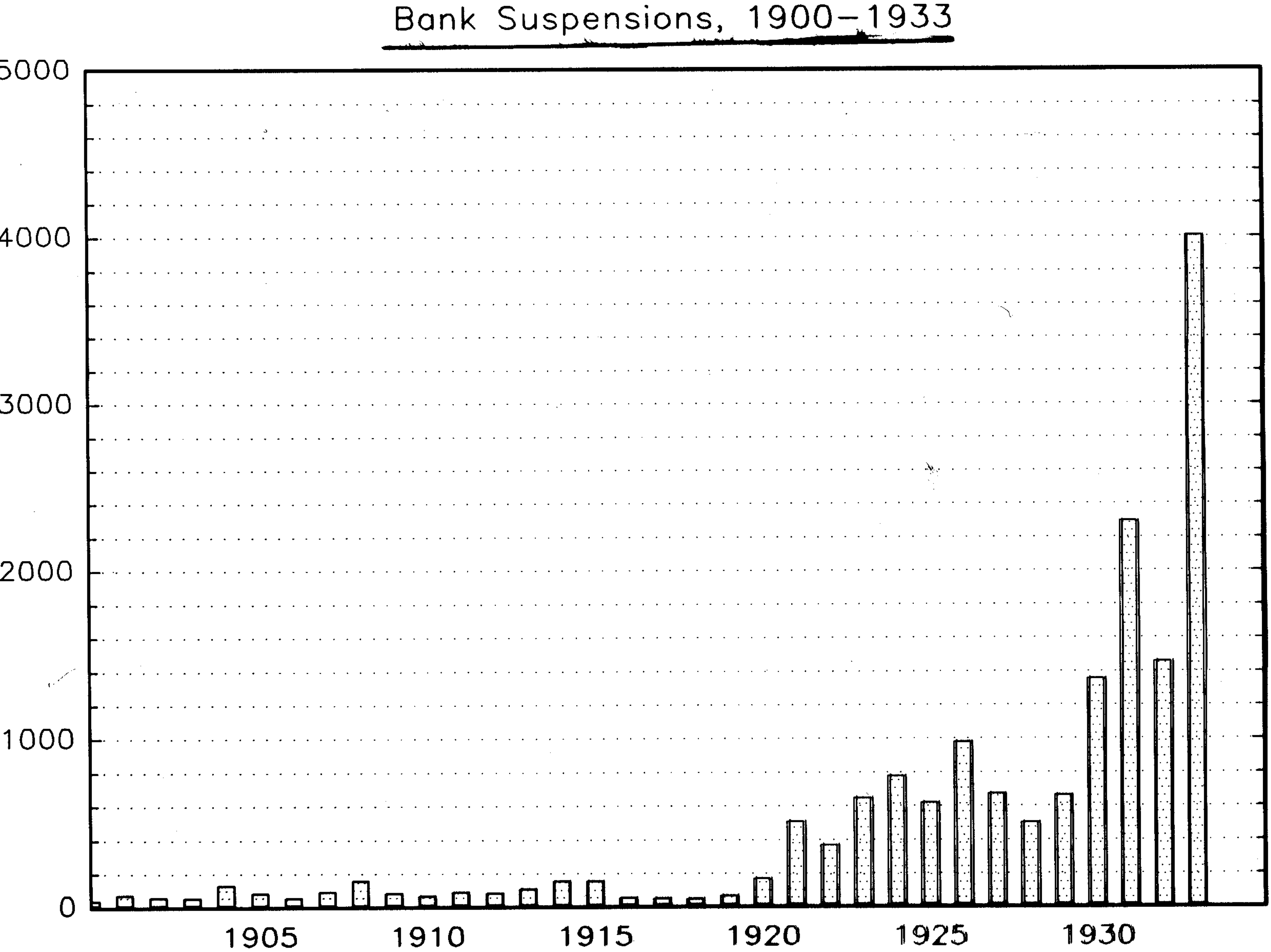
Today

Bank + Thrift Deposit Insurance

+ Regulation

M+B 28


Bank Suspensions, 1900-1933
5000
4000
3000
2000
1000
0
1905
1910
1915
1920
1925
1930

Commercial Bank Suspensions and Depositor Losses, 1921-1933

Year	Number of Suspensions	Losses as a Percent of Deposits in all Commercial Banks
1921	506	0.21%
1922	366	0.13
1923	646	0.19
1924	775	0.23
1925	617	0.16
1926	975	0.21
1927	669	0.15
1928	498	0.10
1929	659	0.18
1930	1,350	0.57
1931	2,293	1.01
1932	1,453	0.57
1933	4,000	2.15

From *FDIC: A Brief History of Deposit Insurance in the United States*, 1998. (Col. 3 from Friedman and Schwartz).

- Alth suspensions were frequent during 1920's, losses to depositors were small.
- Even 1930-33 losses were not large, on avg.

1930s Legislation

1933 – Int. on Demand Deposits prohibited

- to increase banks' profit margins
  Anti-competitive measure like NIRA.
- made big difference in 1970s, 1980s
- Repealed in 2010 Dodd-Frank Act.

1933 – Glass Steagall Act

- Separated Commercial, Investment Banking
  even as separate corps within holding cos.
- Commercial Banks

  take deposits insured by FDIC

  may not underwrite new securities

- Investment Banks

  May underwrite new securities

  May not take deposits

- CB, Inv. B. may not share controlling ownership
- Repealed 1999

  by Gramm-Leach-Bliley Act.

FDIC Federal Deposit Insurance Corp. 1935

- Insures deposits up to $250,000 (since 2008) per depositor per bank.
- Paid for by assessments on banks. 1/12 % normally
- Grandfathered in existing banks (about 14,000), blocked most further entry (by denying insurance)

→ End of Free Banking Era

Mostly Unit Banks at the time.

Restricted competition + prosperity + π

→ smooth sailing 1943 – 81

1960s — Ceilings placed on savings interest rates. (Fed Reg Q)

Further increases profit margins.

Charters rose in value to 10-20% of deposits.

→ Buyers would pay the FDIC to take over failed banks!

1980 DIDMC Act

Depository Institutions Deregulation
+ Monetary Control Act

- Deregulation

    - Allowed NOW Accts nationwide
      Interest-bearing checkable Deposits
      Banks + Thrifts.

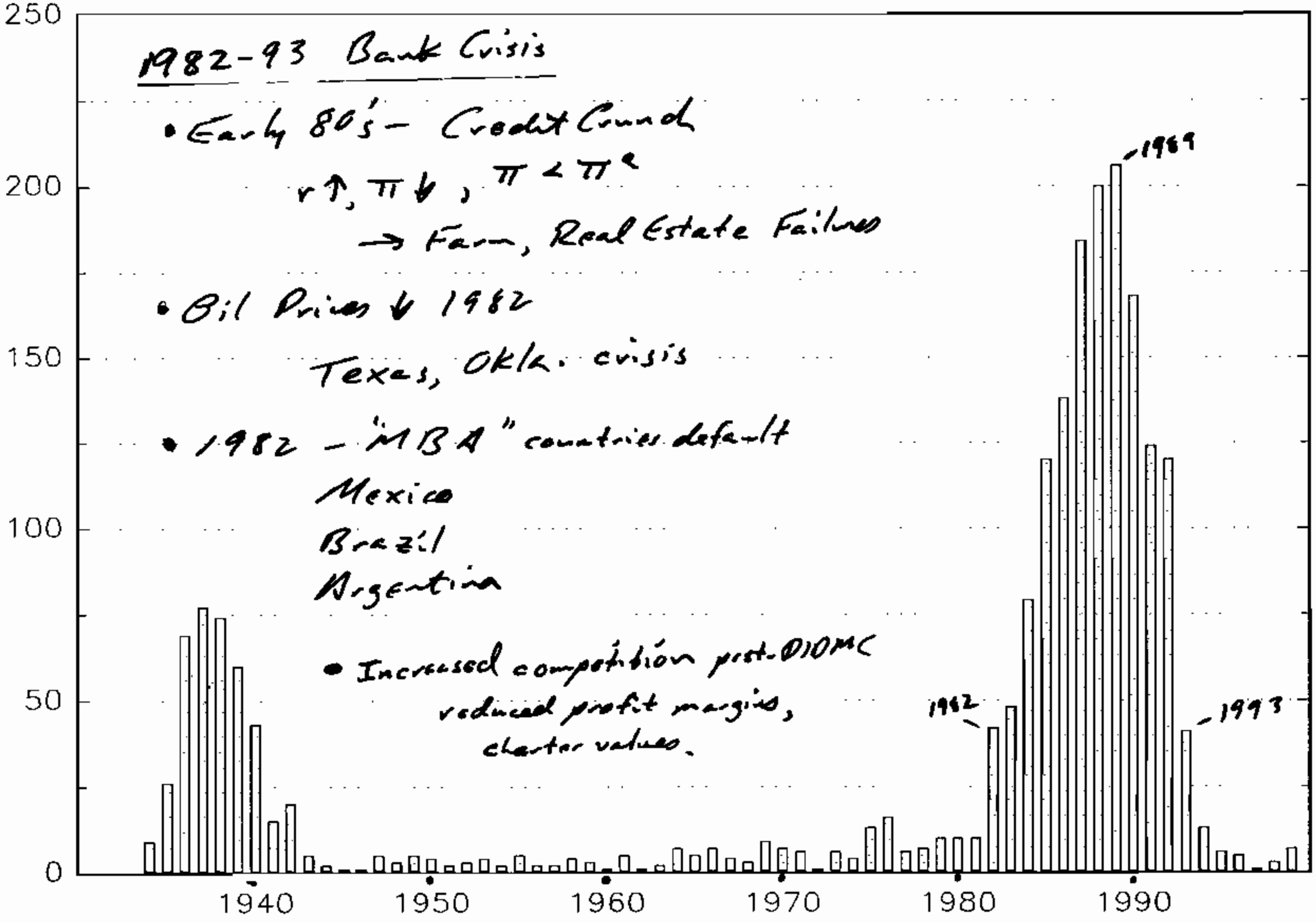
    - Phased out ceilings on Savings, CD
      interest. by 1986.

- M Control

    - Imposed uniform reserve req. on
      all banks, thrifts.

    - Gave all banks, thrifts access to
      discount window.
      formerly only FR Member CBs.

Failures of FDIC/BIF Insured Banks



"Too Big to Fail" (TBTF)
versus "Free to Fail" (FTF)

TBTF unofficial policy since 1984 failure of Continental Illinois N.B.

- Then #7 bank in US.
- Unit Bank under Ill. law.
  - No branches, small deposit base
  - Relied on highly mobile wholesale large CDs, borrowings for growth
- Took over Penn Square Bank's undiversified portfolio of Okla. oil loans.
- Large depositors sensed troubles, ran 5/84
  - Fed advanced ~ $7B discount window
    - Until uninsured large CDs matured.
    - Thwarted $100K dep. insurance ceiling.
  - FDIC took over $4.5B bad assets from Fed

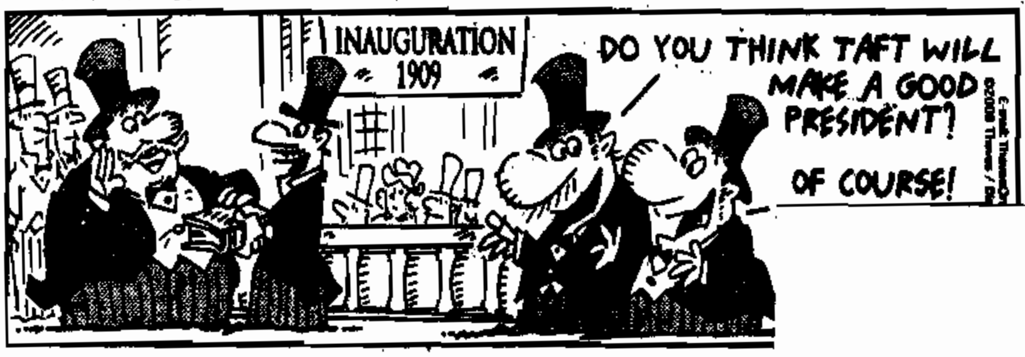
TBTF gives big banks competitive advantage over small banks, since deposits 100% insured.

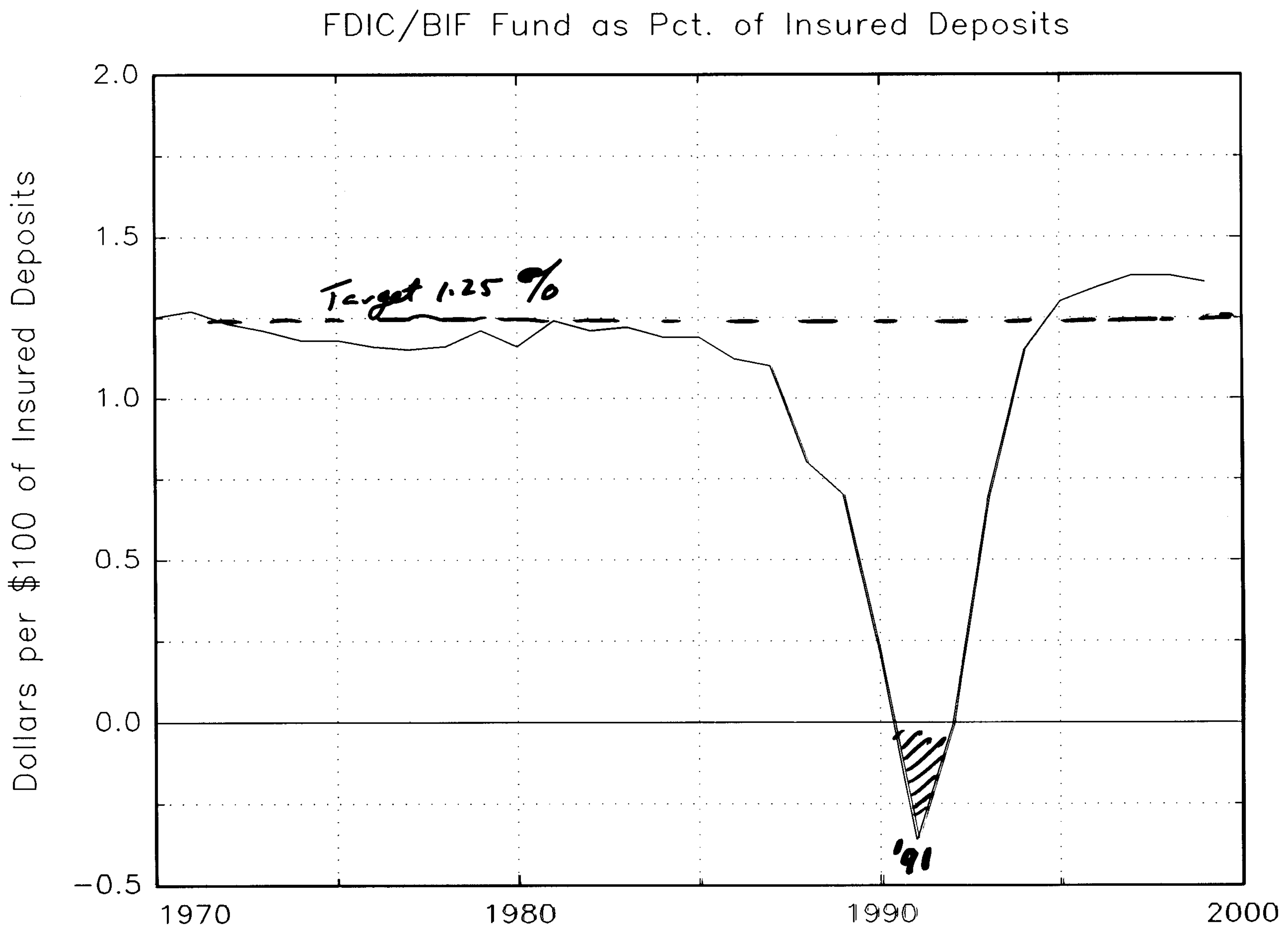
Creates "Moral Hazard"

- Incentive to increase risks.

TBTF, 1909

FRANK & ERNEST BOB THAVES





FDIC/BIF Fund as Pct. of Insured Deposits
Dollars per $100 of Insured Deposits
2.0
1.5
1.0
0.5
0.0
−0.5
1970
1980
1990
2000
Target 1.25 %
'91

- FDICIA 1991

FDIC Improvement Act.

- Created multiple capital zones

$> 5\%$
- minimal regulation

$< 5\%$
- No brokered deposits

$< 4\%$
- No dividends
- Growth restricted

$< 3\%$
- Recapitalization ordered.
- Officers' pay restricted
- Deposit interest rates restricted.

$< 2\%$
- Receivership mandated
- No payments on subordinated debt.

⇒ Preemptive receivership before default!

- FIDICIA Cont'd

  - Risk-Based deposit insurance premia

    Highest for weakest banks, thrifts.

    1995 — BIF restored to target 1.25% of insured deposits, premiums for good banks minimal.

    Crisis resolved at bank, not public, expense.

- Protecting Uninsured Depositors restricted.

  - Prohibited if causes loss to Fund.

  - Except if "severe adverse effects"

  - But losses require special assessment on other insured banks.

End of "Too-Big-to-Fail"?

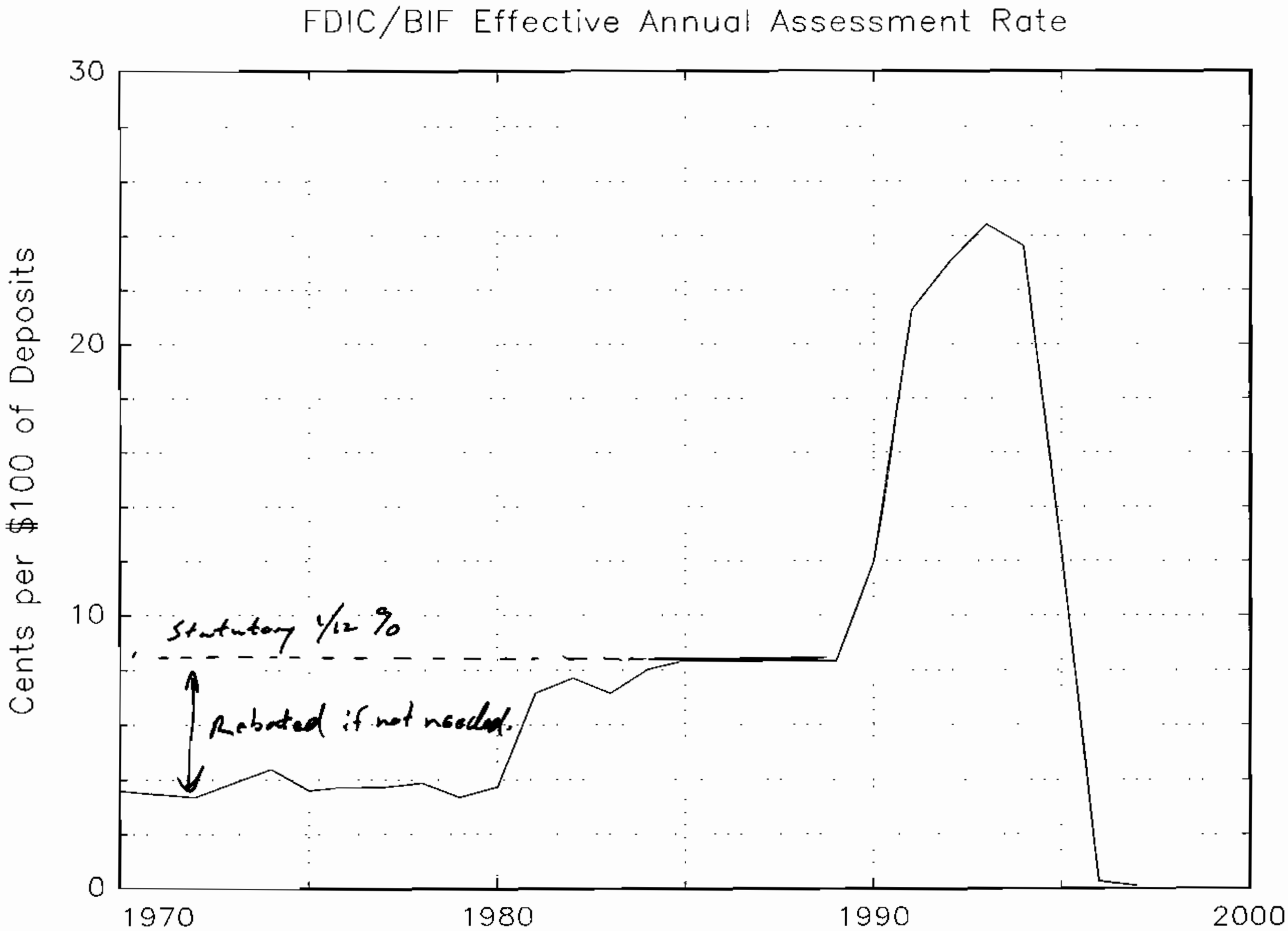
but 2008 - Fed, Treasury bailed out

— Bear Stearns
Fannie + Freddie
AIG
Big BHCs

FDICIA Capital status of BIF-insured banks

"Undercapitalized"
< 4% capital

Year	% of banks
1990	5%
1991	3%
1993	0.5%
1996	0.2%


FDIC/BIF Effective Annual Assessment Rate
Cents per $100 of Deposits
30
20
10
0
1970
1980
1990
2000
Statutory 1/12 %
Rebated if not needed.

- Riegle-Neal Interstate Banking and Branching Efficiency Act 1994

allows interstate branching outright.

- first time since 2nd BUS, 1836!

→ Better diversification
Canada 30's

→ Efficiencies
Scale economies

→ More competition

→ Fewer small local banks.

→ One Big Bank?

Principal - Agent Problem

In big firms, Principal (shareholders) may lose control of Agents (managers)

Eg

- Barings Bank (1762-1995)
  - Rogue Trader Nick Leeson lost $1.3 B trading futures contracts
  - Took down bank.
- Dai-ichi Kangyo Bank, Daiwa bank
  - Rogue Traders incurred huge losses.
- AIG
  - Rogue Credit-Swap dept caused huge losses.
- Wall St. Generally
  - Rogue. NINJA Mortgages, MBS's

Favors smaller banks.

- Offsets scale economies favoring larger banks

But TBTF imposes rogue trader losses on taxpayers, not shareholders.

Banks in US

1933 - 1980s

almost constant near 14,000

1998

down to 8,774,
those controlled by far fewer
holding co's.

Branches

1955 - 7,000

1975 - 30,000

1998 - 62,000

Bank Holding Companies

Most US CB's now held by Holding Co's

Holding Co's debt is <u>not</u> FDIC insured.

Purposes
- Double Leverage
- Allows operational merger without financial merger.
- Pre-1994
  Skirted ban on interstate branching.
- 1970's, 80's
  Skirted bans on intra-state branching.
- Allows coordination of commercial, investment banking since 1999 repeal of Glass-Steagall

Insured CB makes large loans to risky I.B.

Glass-Steagall Repeal 1999

- Gramm-Leach-Bliley Act

- Holding Co's may now hold
  - Commercial Banks
  - Investment Banks
  - Insurance Co's
  - etc

- But CB's are still separately incorporated firms with Limited Liability.
  - CB not liable for debts of HC
  - HC not liable for debts of CB
    At worst, loses equity.
  - HC Debts not FDIC insured.

- "Firewalls" were supposed to protect C.B. from I.B. risks, but largely forgotten.

- BHCs operate on business lines, not legal lines. May have 100's of legal entities in dozens of countries. Hard to separate which owns what + when.

S+L Crisis of 1980's

Federal Home Loan Banking Act 1932

Created –

- ~~Federal~~ Federal S+L's
  - 30 yr Fixed Rate Mortgages from 0-maturity Passbook Savings
  - ⇒ Severe i-risk.
- Federal Home Loan Banks
  - Sell bonds, lend to S+L's.
- FHLB Board
  - to Regulate S+L's, FHLBs.
- FSLIC
  - to insure S+L's. (after 1934)

1950–82

- $i \uparrow, \uparrow, \uparrow$.

⇒ PV of Assets $\downarrow, \downarrow, \downarrow$.,

PV of Liabilities const.

⇒ Economic NW $\downarrow\downarrow\downarrow$, even < 0.

By 1982, Economic NW of S+L's $< -\$100$B.

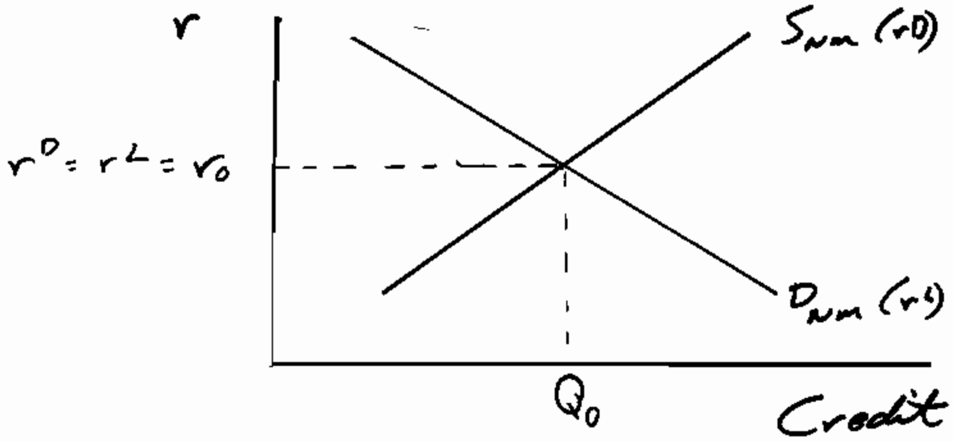
⇒ FSLIC Economically insolvent.

Savings Deposit Interest Ceilings (Fed Reg Q)

1960s, 70s effort to restore Thrift profitability

No Ceilings –

- Most credit intermediated
- Deposit rate r^D = Loan rate $r^L = r_0$
  (abstracting from costs)
- Profits $\rightarrow 0$
  (net of normal return to capital)



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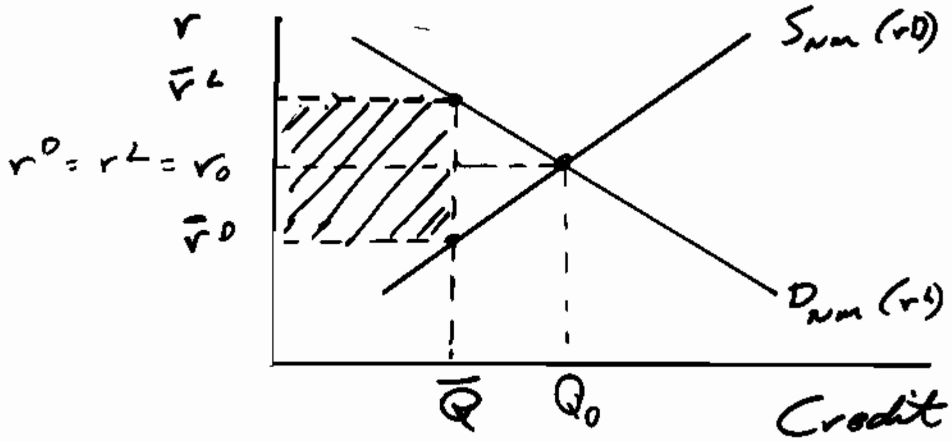


Deposit Interest Ceiling $\bar{r}^D < r_0$:

- Reduces credit supplied to FI's to

  $\bar{Q} = S(\bar{r}^D) < Q_0$
- Demand by borrowers forces r^L up to

  $\bar{r}^L$, where $D(\bar{r}^L) = \bar{Q}$
- Profits ↑ to ▨ $= (\bar{r}^L - \bar{r}^D) \cdot \bar{Q} > 0$

Disintermediation

1960's, 70's

- Savers bypass intermediaries to avoid deposit interest ceilings.

- $1,000 T-Bills popular in 60's,
  Min Denomination ↑ to $10,000 in 1970
  to rescue S+Ls!

- Money Market Mutual Funds
  - Early 70's
  - Hold only very short term (~20 days), highly marketable debt securities
    - T-Bills
    - Corporate Commercial Paper
    - Bank Large CDs
      - > $100,000 deregulated early, negotiable

    ⇒ PV very stable
  - Allow limited "checks"
    - Payable through CB
  - Uninsured, but very safe
    - No R-risk, runproof
    - Regulated by SEC
  - Took off 1979-82
  - Withstood 25% loss of deposits Jan. 1983, without incident, due to MMDA's. Still popular.

House Concurrent Resolution #290

1982

Placed "Full Faith + Credit of US" behind Insured Deposits

- ⇒ taxpayers, not depositors, would bear any losses from S+L closings.

- Prevented runs on insolvent thrifts,

- Created "Moral Hazard" problem, Misinvestments

Garn - St Germain Act of 1982

- Authorized MMDAs

  to attract funds back from

  MMMFs to thrifts, banks.

  - Unregulated i^D
  - Limited Checking, (6/mo)
  - Federally insured.

- Expanded Loan powers of Thrifts

  Some Commercial loans,
  still retain tax advantages.

- Allowed FSLIC to give thrifts

  Net Worth Certificates

  to delay resolutions.

  - "Forbearance" device.
  - Fictitious assets for S+Ls, since
    FSLIC itself insolvent (economically).
  - Allowed insolvent S+L's to stay
    in business as Ponzi Funds.

Forbearance (1980's)

S+L closings delayed.

Net Worth Certificates

RAP vs GAAP

Generally Accepted Accounting Principles

(most corps)

Regulatory Acctg Principles

Permitted to S+L's in 80's.

⇒ Insolvent S+L's stayed in business through '80's.

"Zombie Thrifts"

- Ed Kane

Acted as Ponzi Funds.

1980's

Thrift NW < 0

"End Game Strategy"
Speculative investments preferred

Brokered Deposits
- FSLIC, FDIC insures deposits
  To $100,000/depositor/institution

- Brokers direct large sums to most
  Reckless thrifts, @ $100,000 each.
- Tolerated by regulators!

1989 -- FSLIC Closed
Cost to taxpayers estimated at $175 Billion
($750/capita)

- FIRREA 1989

  Financial Institutions Reform, Recovery & Enforcement Act.

  - Closed FHLBB
  - Closed FSLIC
  - Created OTS

    Office of Thrift Supervision
  - Created SAIF

    to be operated by FDIC separately from BIF.
    (Merged into DIF in 2006)
  - Bailed out FSLIC-insured thrift depositors

    Along with uninsured large deposits.

After 1980s —

- S+L's lost former market share of mortgage intermediation.

- Replaced by

  - Commercial Banks

    Now biggest borrowers from FHLBs!

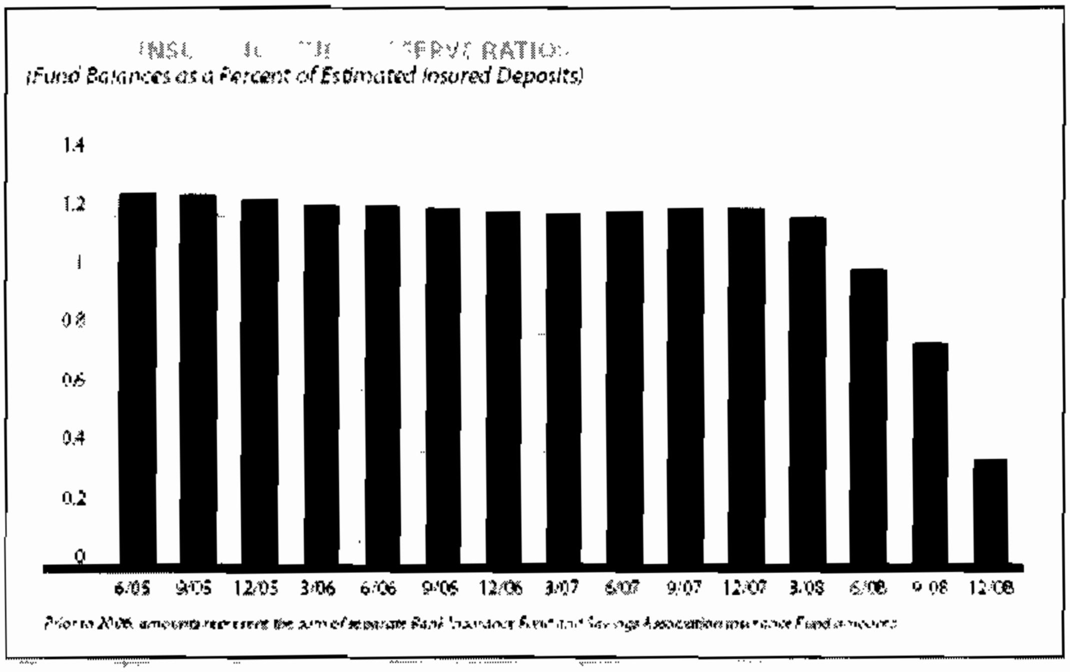
  - Fannie Mae + Freddy Mac
    - Patronized by Sen Ch. Dodd, Rep B. Frank.
    - Encouraged to make risky loans w/
      - low equity
      - high Payment/Income ratios.
    - Forbearance –
      - low, even neg. capital
      - late financial statements.

  - Federal Reserve

    Since 2008, acquired $1.25T in mortgages, F+F Debt.

2008 Banking Crisis.

FDIC Deposit Insurance Fund
(DIF merges Bank Ins. Fund and Savings Assn. Ins. Funds in 2006)
Target level = 1.25% of Insured deposits (permitted range for target 1.15% - 1.50%)



source: FDIC 2008 Annual Report

Bank Failures

2000-2007	averaged 4/yr
2008	25
2009	124 (as of 11/23)

10/2009 FDIC won't say what current DIF reserve ratio is, but plans to assess banks 3 years' premiums in advance to make up shortfall.

TARP

- Troubled Asset Relief Program

  Oct. 2008

- Gave Treasury discretion to buy up to

  $700 B in "Troubled Assets"

- Treas Sec Paulson* advanced ~$250 B

  to Bank Holding Co's (not CBs)

  as Preferred Stock.

  - Protected HC creditors, shareholders

    not FDIC or Depositors.

  - Citigroup $50 B (plus $302 B asset Guarantee)
  - Bank of Am., $45 B (plus $118 B asset Guarantee)
  - AIG $40 B (owed Goldman Sachs $8.1 B)
  - JPMorganChase $25 B
  - Wells Fargo $25 B
  - GM $13.4 B
  - Goldman Sachs $10 B (Converted to BHC just in time to qualify)
  - Morgan Stanley $10 B
  - etc

* Former CEO, Goldman Sachs.

- WSJ estimated Recipients owed $40 B in

  Deferred Comp. to current, former executives.

Dodd - Frank Wall St Reform + Consumer Protection Act of 2010

- Over 2000 pages
- Sponsored by chief patrons of Fan + Fred.

  Does nothing to resolve F + F insolvencies.

- Creates New Agencies
  - Consumer Financial Protection Bureau
  - Financial Stability Oversight Council
  - Office of Financial Research
    in Treasury
  - Offices of Minority and Women Inclusion
    in each federal banking + securities
    regulatory agency.
  - Office of Housing Counseling
    in SEC
  - Office of Credit Ratings
    in SEC
  - Federal Insurance Office
    in Treasury

Some Provisions of Dodd-Frank

- Ends TBTF at taxpayer expense as had 1991 FDICIA...
- But FDIC may guarantee debt of solvent insured banks to prevent runs.
- Restricts Fed from using 13(3) emergency lending authority to bail out individual companies.
  - Must be broad-based (like TARP)
- Requires GAO audit of all crisis 13(3) lending. Due 12/1/10!
- Repeals 1932 prohibition of i on business DDs!
- Makes $250,000 deposit ins. permanent.
- Abolishes "dysfunctional" Off. of Thrift Supervision
- Imposes restrictions on minerals from Dem. Rep. of Congo
- Doesn't mention F+F problem.

Proposed Reforms

Paul Volcker —

Reinstate Glass-Steagall

- Separate insured CBs from risky Investment Banking.

Wm Isaac (Chair of FDIC, 1981-85)

Reinstate Historical Cost Accounting.

Under Mark-to-Market Acctg,

- firms distribute paper profits as dividends
- Then are short on capital when market values fall.

Market for most securities thin.

Historical cost reflects bank's considered judgement.