BANKING REGULATION:
CAUSES, CONSEQUENCES AND IMPLICATIONS FOR THE FUTURE

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February 2005

I. Introduction

What do banks do?

Take deposits (liquidity production), originate and hold loans, and allocate credit

Modern role changing toward originate and sales of loans
- Role is evolving over time due to regulation, market forces, & technology
  - Market share of banks over long time frame
    - Relative to financial institutions shares
    - Relative to total financing to non-financial firms

Public & Private interest rationales for regulation (broadly defined)
- Public: Liquidity risk; systemic risk, etc.
- Private: Limit competition through price and entry limits; subsidies via deposit insurance and central bank services, credit allocation ("off balance sheet fiscal arms of the state")

Main questions/themes of the paper

1) Where does regulation come from?
   - How does structure of banking, in turn, shape regulation via politics?
     - Strength of key interest groups shapes outcome (small v. large US banks; insurance v. banking)
     - International (Basle I & II)

2) How does regulation shape structure and role of banks? Or, how does market adapt to a given set of regulatory constraints?
   - Institutional and contractual innovation; Emergence of VC, investment banking following Glass Steagall
   - Benefits of regulatory competition

3) What is the real impact of regulation of banking?

Structural, operational, and risk consequences for the banking industry
Impact of efficiency and stability of banking on economic growth

4) Why do regulations change?

Private interest: Large macro and/or technology shocks can alter the political equilibrium by changing strength of interest groups

Glass Steagall in 1930s
Deregulation in 1980s

Public interest: cost/benefit of regulation may change due to technology or macro changes

Capital regulation and FDICIA in 1990s

Public & Private sometime intersect: Interest rate shock in 1980s (raised cost of Reg Q) – Both public and private (banks were losing to competitors)

II. Evolution of Key Dimensions of Bank Regulations

Chartering restrictions, geographic restrictions on branching, ownership restrictions (no interstate banking; no ownership by non-banks)

Barrier to entry and limit on corporate control market

US Map for de-regulatory date
US Map for integration change

Origin: Rent extraction by states in 1800s; protection of small banks (interest group politics)

Adaption: Market adjustment (organization structure is endogenous to market forces) to regulation: multi-bank holding company

Bank Holding Company Act constrained this response

Product line restrictions (Glass-Steagall)

Limits role of banks in corporate governance (banks unable to hold non-financial equity)

Despite market adaption to potential conflicts in the 1920s

Origin: Small (raising rival cost) v. large banks. Not private interest: no evidence that conflicts of interest were important

Adaption: Growth of investment banking and VC businesses: VC + pension fund substitute for universal bank; contrast with Europe. Greater financial innovation in these sectors; banker's role on corporate boards, again contrast with Europe/Japan.

Restrictions on price

Reg Q (deposits)
Usury (loans)

Origin: Glaeser & Scheinkmann, Posner

Shock/Adaption: Key court decision allowed credit card market to migrate to states with weakest usury laws (SD and DE); pressure from non-bank competitors

Deposit insurance

Moral hazard problem understood all along
Continuous growth until 1980, then stagnation
Origin: Small bank political clout
Adaption: Maximize deposit insurance subsidy through increased risk and higher asset risk (early 1980s S&Ls)

Regulation of bank capital

No capital-asset regulation until 1980s
Strengthened following S&L debacle
FIRREA & FDICIA
Origin: public interest - reduce moral hazard from deposit insurance
Adaptation: restructure balance sheet (see below)

Risk-based capital for international banks (Basle I & II)

Origin: private interest (US & European banks) fear of non-level playing field
Adaption: 1990s capital requirements generally non-binding - banks act to reduce capital constraint by altering their balance sheets (e.g. securitization). But, market rewards high capital to play in capital market business such as trading and derivatives dealing.

Table with summary of key regulations and legislation

III. Consequence of Regulations

Impact on banking industry structure and operations

1) Fragmented due to branching and activity restrictions
Many banks
No cross state ownership (dis-integrated system)
After deregulation:
Consolidation
Larger average banks size
Increased concentration at state and national levels (but not at local MSA level)
Increase in multi-state bank holding companies

2) Bank risk: higher due to deposit insurance
Moral hazard led to low capital (high leverage), risk taking
Risk constrained by market power until 1970s
S&Ls and banks in the 1980s

3) Costs and prices of bank services
High costs, high wages & high prices (loan interest rates) due to limits on competition (branching restrictions)

Decline in non-interest costs and loan prices after branching deregulation
Increased market share of high-profit banks after deregulation

4) Periodic episodes of disintermediation due to price restrictions

Broad impact on the economy: Growth, Entrepreneurship, Risk-sharing
1) Slower economic growth due to inefficient banking
Acceleration in state-level growth after branching deregulation
More creation of new firms after interstate banking deregulation
More small firms after interstate banking
2) More state-level growth volatility
Better cross-state risk sharing after interstate deregulation
Lower volatility of state economic growth after interstate deregulation
3) More banking, less crime?

Impact of entry into new markets – Investment Banking
Pricing effects in securities underwriting
More competition after banks allowed to underwrite in the late 1980s
Lower underwriting fees (Sufi)
Some evidence that bond yields and equity underpricing of IPO falls if underwriter has lending relationship (Schenone: lower IPO underpricing for firms with a pre-existing lending relationship with potential underwriter)

IV. Forces Driving Deregulation

Public interest: Large shocks that increase the deadweight cost of regulation or reduce its net benefits can lead to deregulation
Private interest: Large shocks may also change the balance between interest groups, again leading to regulatory change.
Note that these two stories need not be in conflict

Several large shocks affected the formerly stable banking regulatory regime, beginning in the 1970s:

-Technology (ATMs, credit bureaus, telecommunications & IT)
Increased ability of large banks to compete against small
Weakened small bank ability to resist

-Growth of competition in alternative institutions and securities markets
Commercial paper, junk bonds, money market mutual fund
Banks want to be able to compete in these markets, thus begin to support deregulation

-Lower demand for currency/check (new payments: credit and debit cards)
Reduces the role of traditional intermediary (deposit+lending)
Again, banks want to be able to move into non-traditional activities such as underwriting, loan sales, securitization and loan syndication

-Macro shocks
Inflation, S&L & banking crises

-Legal shocks from Courts can also lead to regulatory change
Decision that an ATM did not constitute a branch
Decision that allowed credit card market to migrate to states with weakest usury laws

V. Conclusion and Future Regulatory Issues

Conflicts in financial conglomerates
Likelihood of further consolidation / nationwide banking
Currently no bank can have more than 10 percent of total deposits
Future of small banks & deposit insurance coverage
New capital regulations (implementation of Basle II across large vs small banks)
Banks and real estate (currently controversial implementation)
Will SEC or Fed be the primary regulator?
Financial innovation (e.g. securitization & accounting reform)
Regulation of insurance: state or national?

Table 1: Major Legislative Changes in Bank Regulation during the 1980s and 1990s

	Year	Major Provisions of the Law
Depository Institutions Deregulation and Monetary Control Act (DIDMCA)	1980	Raised deposit insurance from $40,000 to $100,000. Phased out interest rate ceilings. Allowed depositories to offer NOW accounts nationwide. Eliminated usury ceilings. Imposed uniform reserve requirements on all depository institutions and gave them access to Fed services.
Garn St Germain Act	1982	Permitted money market deposit accounts. Permitted banks to purchase failing banks and thrifts across state lines. Expanded thrift lending powers.
Competitive Equality in Banking Act (CEBA)	1987	Allocated $10.8 billion in additional funding to the FSLIC. Authorized forbearance program for farm banks. Reaffirmed that the "full faith and credit" of the Treasury stood behind deposit insurance.
Financial Institutions Reform, Recovery and Enforcement Act (FIRREA)	1989	Provided $50 billion of taxpayers' funds to resolve failed thrifts. Replaced Federal Home Loan Bank Board with the Office of Thrift Supervision to regulate and supervise thrifts. Restructured thrift deposit insurance and raised premiums. Reimposed restrictions on thrift lending activities. Directed Treasury to study deposit insurance reform.
Federal Deposit Insurance Corporation Improvement Act (FDICIA)	1991	Imposed risk-based deposit insurance pricing. Required "Prompt Corrective Action" of weakly capitalized banks and thrifts and restricted "Too Big To Fail." Directed the FDIC to resolve failed banks and thrifts in the least costly way to the deposit insurance fund.
Riegle-Neal Interstate Banking and Branching Efficiency Act	1994	Permitted banks and bank holding companies to purchase banks or establish subsidiary banks in any state nationwide. Permitted national banks to open branches or convert subsidiary banks into branches across state lines.
Gramm-Leach-Bliley Financial Modernization Act	1999	Authorizes Financial Holding Companies (FHCs) to engage in a full range of financial services, e.g., commercial banking, insurance, securities, and merchant banking. Gives Fed and Treasury discretion to authorize new financial activities or complementary activities for FHCs. Establishes Fed as "umbrella" regulatory for FHCs. Provides low-cost credit to community banks. Reforms Community Reinvestment Act. Eliminates unitary thrift holding companies.

Table 2: Broad Trends in Commercial Banking, 1950-1995.

Year	Number of ATMs	Domestic Bank Deposits (Billions)	Money Market Mutual Fund (Billions)	Percent of Deposits + Money Funds Held by Banks	Small Banks' Percent of Banking Assets	Average Number of Bank Failures
	(1)	(2)	(3)	(4)	(5)	(6)
1950	0	$154	$0	100	NA	4
1955	0	191	0	100	NA	3
1960	0	228	0	100	24	2
1965	0	330	0	100	20	4
1970	0	479	0	100	18	6
1975	9,750	775	4	99	18	6
1980	18,500	1,182	76	94	17	10
1985	61,117	1,787	242	88	14	60
1990	80,156	2,339	493	83	11	179
1995	122,706	2,552	745	77	8	61

Notes and Sources:
Column 1: ATM figures are from Bank Network News, The EFT Network Data Book (New York: Faulkner and Gray, Inc.). The 1975 figure was unavailable. 9,750 is the number of ATMs in 1978, the first year for which complete data are available.

Columns 2-4: Banks domestic deposits are from the Reports of Income and Condition; money market mutual funds are from the Flow of Funds. Data on all bank deposits, foreign plus domestic are only available beginning in 1970. The trend in banks' share (column 4) is the same using total deposits instead of domestic deposits.

Column 5: Percent of banking assets held by small banks, where a small bank is defined as a commercial bank less than $100 million in assets in 1994 dollars. These data are based on the Reports of Income and Condition. Data on small banks are not available before 1960.

Column 6: Five year average number of bank failures, where the final year is indicated in the first column. These data are from FDIC, Annual Report and the Quarterly Banking Profile.

Table 3:
Percentage shares of assets of financial institutions in the United States (1860-1993)

	1860	1880	1900	1912	1922	1929	1939	1948	1960	1970	1980	1993
Commercial banks	71.4	60.6	62.9	64.5	63.3	53.7	51.2	55.9	38.2	37.9	34.8	25.4
Thrift institutions	17.8	22.8	18.2	14.8	13.9	14.0	13.6	12.3	19.7	20.4	21.4	9.4
Insurance companies	10.7	13.9	13.8	16.6	16.7	18.6	27.2	24.3	23.8	18.9	16.1	17.4
Investment companies	--	--	--	--	0.0	2.4	1.9	1.3	2.9	3.5	3.6	14.9
Pension funds	--	--	0.0	0.0	0.0	0.7	2.1	3.1	9.7	13.0	17.4	24.4
Finance companies	--	0.0	0.0	0.0	0.0	2.0	2.2	2.0	4.6	4.8	5.1	4.7
Securities brokers and dealers	0.0	0.0	3.8	3.0	5.3	8.1	1.5	1.0	1.1	1.2	1.1	3.3
Mortgage companies	0.0	2.7	1.3	1.2	0.8	0.6	0.3	0.1	[a]	[a]	0.4	0.2
Real estate investment trusts	--	--	--	--	--	--	--	--	0.0	0.3	0.1	0.1
Total *(percent)*	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total *(trillion dollars)*	.001	.005	.016	.034	.075	.123	.129	.281	.596	1.328	4.025	13.952

[a] Data not available.

Sources: Data for 1860-1948 (except 1922) from Goldsmith (1969, Table D-33, pp. 548-9); data for 1922 from Goldsmith (1958, Table 10, pp. 73-4); and data for 1960-1993 from Board of Governors of the Federal Reserve System, "Flow of funds accounts," various years. The table is expanded from Kaufman and Mote (1994).