Chapter 10

Free-rider problem, because depositors lack information about the quality of these private loans.

Bank failure, in which a bank is unable to meet its obligations to pay its depositors and other creditors, and so must go out of business) meant that depositors would have to wait until the bank was liquidated to get their deposit funds

Depositors’ lack of information about the quality of bank assets can lead to a bank panic, in which many banks fail simultaneously. b/c the simultaneous failure of many banks leads to sharp decline in bank lending, bank panics have serious, harmful consequences for the economy.

A government safety net for depositors can short-circuit runs on banks and bank panics, and by providing protection for the depositor, it can overcome depositors’ reluctance to put funds into the banking system.

One form of safety net is deposit insurance, such as that provided by the Federal Deposit insurance Corporation (FDIC) of the U.S. The FDIC guarantees that current depositors will be paid off in full on he first $250,000 they have deposited in a bank if the bank fails. With fully insured deposits, depositors don’t need to run to the bank to make withdrawals – even if they are worried about the bank’s health

The FDIC uses two primary method to handle a failed bank. First, payoff method, the FDIC allows the bank to fail to pays off depositors up to the $250,000 insurance limit. After the bank has been liquidated, the FDIC lines up with other creditors of the bank and is paid its share of the proceeds from the liquidated assets. The second method, called the purchase and assumption method, the FDIC reorganizes the bank, typically by finding a willing merger partner who assumes (takes over) all of the failed bank’s liabilities so that no depositors or other creditor loses a penny.

The net effect of the purchase and assumption method is tht the FDIC has guaranteed all liabilities and deposits, not just deposits under the $250,000 limit.

The most serious drawback of the government safety net stems from moral hazard, the incentive of one party in a transaction to engage in activities detrimental to the other party.

With a safety net, depositor and creditors know they will not suffer losses if a financial institution fails, so they do not imposes the discipline of the marketplace on these institutions by withdrawing funds when they suspect that the financial institution is taking on too much risk. Consequently, Financial institutions with a government safety net have an incentive to take on greater risks than they otehrwise would, b/c taxpayers will foot the bill if the bank subsequently goes belly up. Financial institutions can place the following bet: “Heads, I win, tails, the taxpayers loses.”

government safety net like deposit insurance is adverse selection,b/c depositors and creditors protected by a government safety net have little reason to impose discipline on financial institutions, ris-loving entrepreneurs might find the financial industry a particularly attractive one—they know they will be able to engage in highly risky activities. Moreover, b/c protected depositors and creditors have so little reason to monitor the financial institution’s activities, without government intervention outright crooks might also find finance an attractive industry for their activities b/c it is easy for them to get away with fraud and embezzlement.

Too-big-to-fail problem, in which regulators are reluctant to close down large financial institutions and imposes losses on the institution’s depositors and creditors b/c doing so migh precipitate a financial crisis.

With financial innovation and the passage of the Riegle-Neal Interstate banking and branching Effciency Act of 1994 and the Gramm-Leach-Bliley Financial Services Moderniation Act in 1999, financial consolidation has bee proceeding at a repaid pace, leading to both large and more complex financial organizations.

Financial consllidation poses two challenges to financial regulations b/c of the existence of the government safety net. First, the increase size of financial institutions resulting from financial consolidation increase the too-big-to-fail problem, b/c there are now more large institutions whose failure would exposes the financial system to systemic (system-wide) risk. Second, financial consolidation of banks with other financial services firms means that the government safety net may be extended to new activities, such as securities underwriting, insurance, or real estate activities, as occurred during the global financial crisis.

There are eight basic types of financial regulation aimed at lessening asymmetric information problems and excessive risk taking in the financial system: 1) restriction on asset holding, 2) capital requirements , 3) prompt corrective action, 4) chartering and examination, 5) assessment of risk management, 6) disclosure requirements, 7) consumer protection, and 8) restrictions on competition.

A strong rationale for government regulation aimed at reducing risk taking on the part of financial institutions therefore existed even before the establishment of government safety nets like federal deposit insurance.

Promote diversification, which reduces risk by limiting the dollar amount of the loans in particular categories or to individual borrowers.

With the extension of government safety net during the global financial crisis, and the calls for regulatory reform in its aftermath, it is likely that nonbank financial institution may face greater restrictions on their holdings of risky assets in the future.

When a financial institution is forced to hold a large amount of equity capital, the institution has more to lose if it fails and is thus more likely to pursue less risky activities.

Leverage ratio, the amount of capital divided by the bank’s total assets. A bank’s leverage ratio must exceed 5%; a lower leverage ratio, especially one below 3%, triggers increase regulatory restrictions on the bank.

Off-balance-sheet activities, which do not appear on bank balance sheet but nevertheless expose banks to risk, involve trading financial instruments and generating income from fees.

Basel committee on banking supervision, which implemented the Basel Accord, which deals with a second type of capital requirements, risk-based capital requirements. The Basel Accord, which requires that banks hold as capital at least 8% of their risk-weighted assets, has been adopted by more than 100 countries, including the U.S.

The first category carries a zero weight and includes items that have little default risk, such as reserves and government securities issued by the Organization for Economic Cooperation and Development (OECD – industrialized) countries. The second category has a 20% weight and includes claims on banks in OECD countries. The third category has a weight of 50% and included municipal bonds and residential mortgages. The fourth category has the maximum weight of 100% and includes loan o consumers and corporations.

Regulatory arbitrage, a practice in which banks keep on their books assets that have the same risk-based capital requirement but are relatively risky

The Basel Accord thus might lead to increased risk taking, the opposite of its intent.

If the amount of a financial institution’s capital falls to low levels, two serious problems result. First, the bank is more likely to fail b/c it has a smaller capital cushion if it suffers loan losses or other asset write-downs. Second, with less capital, a financial institution has less “skin in the game” and is therefore more likely to take on excessive risk.

Federal Deposit Insurance Corporation Improvement Act of 1991 adopted prompt corrective action provisions that require the FDIC to intervene earlier and more vigorously when a bank get into trouble.

Financial supervision or prudential supervision, is an important method for reducing adverse selection and moral hazard in the financial industry.

Chartering financial institutions is one method of preventing this adverse selection problem: through chartering, proposals for new institutions are screened to prevent undesirable people from controlling them.

Regular on-site examinations, which allow regulators to monitor whether the institutions is complying with capital requirements and restrictions on asset holdings, function to limit moral hazard.

The acronym is based on the six areas assessed: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. With information about a bank’s activities, regulators can enforce regulations by taking formal actions such as issuing cease and desist orders to after the bank’s behavior, or even closing a bank if its CAMELS rating is sufficiently low.

Four elements of sound risk management are assessed to arrive at the risk management rating: 1) the quality of oversight provided by the board of directors and senior management; 2) the adequacy of policies and limits for all activities that present significant risks; 3) the quality of the risk measurement and monitoring system; and 4) the adequacy of internal controls to prevent fraud or unauthorized on the part of employees.

Stress test, which calculate potential losses and the need for more capital under fictional dire scenarios, and value-at-risk(VaR) calculations, which measure the size of the loss on a trading portfolio.

Disclosure requirements, with one of its three pillars focusing on increasing market discipline by mandating increased disclosure by banking institutions of their credit exposure, amount of reserve, and capital.

The Securities Act of 1933 and the Securities and Exchange Commission (SEC), which was established in 193, also imposes disclosure requirements on any corporation, including financial institutions, that issues publicly traded securities.

Regulation to increase disclosure is needed to limit incentive to take on excessive risk and to upgrade the quality of information in the marketplace so that investors can make informed decisions, thereby improving the ability of financial markets to allocate capital to its most productive uses.

The Sarbanes-Oxley Act of 2002 took disclosure of information even further by increasing the incentive to produce accurate audits of corporate income statements and balance sheets, establishing the Public Company Accounting Oversight Board (PCAOB) to oversee the audit industry, and putting in place regulations to limit conflicts of interest in the financial services industry.

The consumer Protection act of 1969 requires all lenders, not just banks, to provide information to consumers about the cost of borrowing, including the disclosure of a standardized interest rate (called the annual percentage rage, or APR) and the total finance charge on the loan.

The fair credit billing act of 1974 requires creditors, especially credit card issuers, to provide information on the method of assessing finance charge, and requires that billing complaints be handled quickly.

Declining profitability resulting from increased competition could tip the incentive of financial toward assuming greater risk in an effort to maintain former profit levels.