Today

Bank + Thrift Deposit Insurance + Regulation M + B ≥ 8
### Commercial Bank Suspensions and Depositor Losses, 1921-1933

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

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

- All the 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 NRA.
  * 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  * Repealed in 2010 Dodd-Frank Act.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 Bankers
  * take deposits insured by FDIC
  * may not underwrite new securities

* Investment Bankers
  * 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* Repealed 1999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.  1/2% normally
- Severe fetters on 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 + 

→ 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 reg. on all banks, thrifts.

  * Gave all banks, thrifts access to discount window.

  formerly only FR Member CBs.
Failures of FDIC/BIF Insured Banks

1982-93 Bank Crisis

- Early 80's - Credit Crunch
  \( \uparrow \Pi %, \Pi < \Pi \)
  \( \Rightarrow \) Farm, Real Estate Failures

- Oil Prices & 1982
  Texas, Oklahoma crisis

- 1982 - "MBA" countries default
  Mexico
  Brazil
  Argentina

- Increased competition post-DIOMC
  reduced profit margins,
  cluster values.

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

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

- Then #1 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 $400K dep. insurance cut-off.
- FDIC took over $4.5B bad assets from Fed

TBTF gives big banks competitive advantage over small banks since deposit 100% insured. Creates "Moral Hazard"

- Incentive to increase risk.
FRANK & ERNEST

INAGURATION
DO YOU THINK TAFT WILL MAKE A GOOD PRESIDENT?
OF COURSE!

TAFT, 1909
FOIC Improvement Act.

- Created multiple capital zones

\[
\begin{align*}
\text{> 5\%} & \quad \text{minimal regulation} \\
\text{< 5\%} & \quad \text{No brokered deposits} \\
\text{< 4\%} & \quad \text{No dividends} \\
& \quad \text{Growth restricted} \\
\text{< 3\%} & \quad \text{Recapitalization ordered} \\
& \quad \text{Officers' pay restricted} \\
& \quad \text{Deposit interest rate restricted} \\
\text{< 2\%} & \quad \text{Receiviorship mandated} \\
& \quad \text{No payments on subordinated debt} \\
& \quad \text{Preemptive receivership before default!}
\end{align*}
\]
Risk-Based deposit insurance premiums
Highest for weakest banks, thrifts.
1995—BEF raised to target 1.25% of insured deposits, premiums for good banks minimal.
Crisis resolved at bank, not public expense.
6 Protecting uninsured depositors restricted.

- Prohibited if causes loss to Fund.
- Except if "severe adverse effects"
- But losses require special assessment on other insured banks.
"Too-Big-to-Fail"?

But 2008—Fed, Treasury bailed out
- Bear Stearns
- Fannie & Freddie
- AIG
- BHCs
FDICIA Capital Status of BIF-insured banks

"Undercapitalized"
< 4% capital

<table>
<thead>
<tr>
<th>Year</th>
<th>% of banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>5%</td>
</tr>
<tr>
<td>1991</td>
<td>3%</td>
</tr>
<tr>
<td>1993</td>
<td>0.5%</td>
</tr>
<tr>
<td>1996</td>
<td>0.2%</td>
</tr>
</tbody>
</table>
Riegle-Neal Interstate Banking and Branching Efficiency Act, 1994

allows interstate branching outright.

first time since 2nd BUS, 1836!

Better diversification

Cemex 30's

Efficiencies

Scale economies

More competition

Fewer small local bankers.

One Big Bank?
Principal-Agent Problem

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

Ex:
- Baring Bank (1962-1995)
  - Rogue Trader Nick Leeson lost $1.3B trading futures contracts
  - Took down bank.
- Daiichi Kangyo Bank, Dainwa bank
  - Rogue Traders incurred huge losses.
- AIG
  - Rogue Credit-Swop 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
donw to 8,774
these 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 not 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 CBs make large loans to risky IBs.
Glass-Steagall Report 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 NC
  - NC not liable for debts of CB
  - At worst, lose equity.
  - NC Debts not FDIC insured.

- "Firewalls" were supposed to protect CB.
  - 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

- Federal S&L's
  - 30 yr. Fixed Rate Mortgages
  - From Origination by Passbook Savings
  - Severe i-risk.

- Federal Home Loan Banks
  - Sell bonds, lend to S&L's

- FNLB Board
  - to Regulate S&L's, FNLBs.

- FSLIC
  - to insure S&L's. (after 1974)

1950-82
- i, j, t, t, t.
  - PV of Assets i, j, u, v.
  - PV of Liabilities constant.
  - Economic NW ↓ ↓ ↓, even 20.

By 1982, Economic NW of S&L's < $900 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 $r^D = \text{Loan rate } r^L = r_0$
  (abstracting from costs)
- Profits $\rightarrow 0$
  (net of normal return to capital)

\[ r \]

\[ r^D = r^L = r_0 \]

\[ S_{nm}(r^D) \]

\[ D_{nm}(r^L) \]

\[ Q_0 \quad \text{Credit} \]
Savings Deposit Interest Ceilings (Real 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 $\to 0$
  (net of normal return to capital)

![Graph showing supply and demand for credit]

**Deposit Interest Ceiling $r^D < r_0$**
- Reduces credit supplied to FIs to
  $Q = S(r^D) < Q_0$
- Demand by borrowers forces $r^b$ up to $\bar{r}^b$, where $D(\bar{r}^b) = \bar{Q}$
- Profits $\to (\bar{r}^b - r^D) \cdot \bar{Q} > 0$
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 $T-Bills

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
House Concurrent Resolution H.Con.Res. 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,
  misinvestment.
Cass – 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 advantage.

- Allowed FSLIC to give thrifts Net Worth Certificate
to delay resolutions.

  - "Forbearance" device.
  - First tranche, for 5-15, included.
  - FSLIC itself insolvent (originally).
  - Allowed insolvent StLs to stay in business as Ponzi Funds.
Forbearance (1980's)

S&L closing delayed.

Net Worth Certificate

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 Ponti 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 and Enforcement Act.

- Closed FHLBB
- Closed FSLIC
- Created OTS
  Office of Thrift Supervision
- Created SAIF
  to be operated by FDIC
  separately from BIE.
  (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 + Freddie Mac
  - Patronized by Sen. Ch. Dodd,
  - Encouraged to make risky loans w/ low equity, high Payment/Income ratios.
  - Forbearance -
    - low, even neg. capital
    - late financial statements.

- Federal Reserve
FDIC Deposit Insurance Fund
(DIF merges Bank Ins. Fund and Savings Asst. 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

<table>
<thead>
<tr>
<th>Year</th>
<th>Failures</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000-2007</td>
<td>averaged 4/yr</td>
</tr>
<tr>
<td>2008</td>
<td>25</td>
</tr>
<tr>
<td>2009</td>
<td>124 (as of 11/23)</td>
</tr>
</tbody>
</table>

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
  $700B in "Troubled Assets"

- Trans 50c Paulson advanced ~$250B
  to Bank Holding Co's (not B & H)
  as Preferred Stock.

- Protected NC creditors, shareholders
  not FDIC or Depositors.

  - CitiGroup $50B (plus $302B audit variance)
  - Bank of Am. $45B (plus $18B audit variance)
  - AIG $40B (owed Goldman Sachs $8.1B)
  - J.P. Morgan Chase $25B
  - Wells Fargo $25B
  - GM $13.4B
  - Goldman Sachs $10B (owed to NC, just in time
to qualify)
  - Morgan Stanley $10B

  * Former CEO, Goldman Sachs.

- WST estimated recipients owed ~$40B in
  Deferred Coup. to current, former execs.
Dodd - Frank Wall St Reform +
Consumer Protection Act of 2010

- Over 2000 pages
- Sponsored by chief patrons of Fant 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
  - Office of Minority and Women Inclusion
    in each federal banking + securities
    regulatory agency.
  - Office of Borrowing Counseling
    in SEC
  - Office of Credit Rating
    in SEC
  - Federal Insurance Office
    in Treasury
Some Provisions of Dodd-Frank

- Ends TBTF act, 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 ODs.

- Makes $250,000 deposit ins. permanent.

- Abolishes “dysfunctional” OTS of Thrift Supervision

- Imposes restrictions on minority from
  Den. 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 Accruals,

- Firm distributes paper profits as dividends
- Then are short on capital when market values fall.

Markets for most securities thin.

__Historical cost reflects bank's considered judgement.____