CHAPTER FIVE

5. The Regulation of Financial Markets & Institutions

Financial institutions are one of the most regulated of all businesses in the world. Around the globe, these financial-service firms face stringent government rules limiting the services they can offer; the territories they can enter or not enter; the makeup of their portfolios of assets, liabilities, and capital; and even how they price and deliver their services the public.

Many economists, financial analysts and financial institutions have argued over the years that regulation has done more harm than good for both financial institutions themselves and for the public they serve. In particular, government restrictions allegedly have allowed non-regulated or less-regulated financial-service firms to invade the markets and capture many of the customers of highly regulated financial institutions, who are not sufficiently free to compete effectively.

Moreover, regulations are often backward looking, addressing problems that have long since disappeared, and they may compound this problem of "relevancy" by changing much more slowly than the free marketplace, inhibiting the ability of regulated financial institutions to stay abreast of new technologies and changing customer tastes.

Others argue that gov't regulations have achieved some positive results in financial institutions' sector, reducing the number of failed financial-service firms, promoting more stable financial markets, and reducing the incidence of racial, religious, sex and age discrimination in public access to financial services. The government supervision over the operation of FIs is primarily to protect the public's savings and ensuring that consumers receive an adequate quantity and quality of reasonably priced financial services.

5.1 Why Regulate Banks

Although banks are operated for profit and bankers are free to make many decisions in their daily operations, banking is commonly treated as a matter of public interest. Banking laws and regulations extend to many aspects of banking, including who can open banks, what products can be offered, and how banks can expand. Consequently, a familiarity with regulatory objectives and goals is essential for understanding how the system of bank regulation and supervision arose and what the purpose of particular regulations might be.

Much of the regulatory system has developed in response to financial crises and other historical and political events. No central architect was assigned to design the overall system or lay out a single set of principles. Instead, many people with many viewpoints, objectives, and experiences have been responsible for the current supervisory framework. As a consequence, bank regulation has evolved to serve numerous goals — goals which have changed over time and on occasion even been in conflict with one another.

The following sections focus on several of the more commonly accepted goals of bank regulation. Also, because of the potential for conflict among regulatory goals, special attention is given to what banking regulation should not do.

Banking regulation in its strictest sense refers to the framework of laws and rules under which banks operate. Narrowly defined, supervision refers to the banking agencies' monitoring of financial conditions at banks under their jurisdiction and to the ongoing enforcement of banking regulation and policies.

5.1.1 Protection of Depositors

The most basic reason for regulation of banking is depositor protection. Pressure for such regulation arose as the public began making financial transactions through banks, and as businesses and individuals began holding a significant portion of their funds in banks. Banking poses a number of unique problems for customers and creditors. First, many of the bank customers use a bank primarily when writing and cashing checks and carrying out other financial transactions.

To do so, they must maintain a deposit account. As a consequence, bank customers assume the role of bank creditors and become linked with the fortunes of their bank. This contrasts with most other businesses, where customers simply pay for goods or services and never become creditors of the firm.

A second problem for bank depositors is that under the U.S. fractional reserve system of banking, deposits are only partially backed by the reserves banks hold in the form of cash and balances maintained with the Federal Reserve. As a result, depositor safety is linked to many other factors as well, including the capital in a bank and the condition and value of its loans, securities, and other assets. A thorough investigation of these factors is likely to be too complex and costly for the vast majority of depositors, many of whom have accounts too small to justify the scrutiny that might be given to major investments. Even if depositors could accurately assess banks, this condition could change quickly whenever the economy changes or when banks take on new depositors or alter their asset holdings and commitments. In addition, an important part of the information needed to evaluate the condition of a bank may be confidential and unavailable to the public.

In summary, bank depositors may have more difficulty protecting their interests than customers of other types of businesses. While depositors could conceivably make general judgments about the condition of banks, the task would still be difficult, costly, and occasionally prone to error. These facts, especially when combined with the history of depositor losses before federal deposit insurance, explain much of the public pressure for banking regulation to protect depositors.

5.1.2 Monetary and Financial Stability

Apart from just being concerned about individual depositors, banking regulation must also seek to provide a stable framework for making payments. With the vast volume of transactions conducted every day by individuals and businesses, a safe and acceptable means of payment is critical to the health of our economy. In fact, it is hard to envision how a complex economic system could function and avoid serious disruptions if the multitude of daily transactions could not be completed with a high degree of certainty and safety. Ideally, bank regulation should thus keep fluctuations in business activity and problems at individual banks from interrupting the flow of transactions across the economy and threatening public confidence in the banking system.
Historically, monetary stability became a public policy concern because the most severe economic downturns in U.S history were typically accompanied and accentuated by banking panics. Before the creation of the Federal Reserve System in 1913 and the FDIC in 1933, these panics followed much the same pattern. Individual banks and the banking system as a whole held only a limited volume of internal reserves and liquid assets. Consequently, during serious banking and economic problems, these reserves could be quickly exhausted and the value of other bank assets could be put into question, thus giving depositors good reason to fear for the safety of their funds. Such disruptions in the banking

system would further hinder financial transactions and the flow of credit, leading to continued slippages in the overall economy and in depositor confidence.
The Federal Reserve Act sought to prevent such situations by providing for a more elastic reserve base and by allowing banks to borrow funds from Reserve banks to meet depositor needs and credit demands. To provide further confidence to depositors, the U.S. Government instituted federal deposit insurance in the 1930s. This insurance, by eliminating the link between the fate of small depositors and that of their banks, removed any reason for insured depositors to panic at the first sign of banking problems. Although deposit insurance has not been without cost or risk, it has provided stability in the payments system and given bank regulators greater flexibility in resolving individual bank problems.

Several other aspects of state and federal policy have also contributed to monetary stability in the United States. The Federal Reserve has responsibility for controlling the overall volume of money circulating throughout the economy and thus for providing a stable base for our payments system. Banks play an important role in this monetary system, since their deposit obligations make them the major issuers of money in the economy. This role is further acknowledged through specific laws and regulations determining which institutions can offer deposit accounts, the level of reserves that must be held against these accounts, and the various deposit reports that must be filed.
Another policy aspect of monetary stability is supervision and regulation of the banking system. To provide stability, banking regulation should foster the development of strong banks with adequate liquidity and should discourage banking practices that might harm depositors and disrupt the payments system.

In banking regulation, the objective of monetary stability has been closely linked with the goal of depositor protection. Financial crises and unintended fluctuations in the money supply have been prevented primarily by promoting confidence in banks and guaranteeing the safety of deposits.

5.1.3 Efficient and Competitive Financial System

Another aspect of a good banking system is that customers are provided quality services at competitive prices. One of the purposes of bank regulation, therefore, is to create a regulatory framework that encourages efficiency and competition and ensures an adequate level of banking services throughout the economy.

Efficiency and competition are closely linked together. In a competitive banking system, banks must operate efficiently and utilize their resources wisely if they are to keep their customers and remain in business. Without such competition, individual banks might attempt to gain higher prices for their services by restricting output or colluding with other banks. Competition is also a driving force in keeping banks innovative in their operations and in designing new services for customers. A further consideration is that for resources throughout the economy to flow to activities and places where they are of greatest value, competitive standards should not differ significantly across banking markets or between banking and other industries.

The promotion of an efficient and competitive banking system carries a number of implications for regulation. Competition and efficiency depend on the number of banks operating in a market, the freedom of other banks to enter and compete, and the ability of banks to achieve an appropriate size for serving their customers. For instance, too few banks in a market could encourage monopolization or collusion, while banks of a suboptimal size might be unable to serve major customers and might be operating inefficiently.

Consequently, regulators must be concerned with the concentration of resources in the banking industry and with the opportunities for entry and expansion across individual banking markets.
Banking regulation must also take an approach that does not needlessly restrict activities of commercial banks, place them at a competitive disadvantage with less regulated firms, or hinder the ability of banks to serve their customers' financial needs. Finally, regulation should foster a banking system that can adapt and evolve in response to changing economic conditions and technological advances.

5.1.4 Consumer Protection

Another goal of banking regulation is to protect consumer interests in various aspects of a banking relationship. The previous regulatory objectives serve to protect consumers in a number of ways, most notably through safeguarding their deposits and promoting competitive banking services. However, there are many other ways consumers are protected in their banking activities.
These additional forms of protection have been implemented through a series of legislative acts passed over the past few decades. Several basic purposes can be found in this legislation. The first is to require financial institutions to provide their customers with a meaningful disclosure of deposit and credit terms. The main intent behind such disclosures is to give customers a basis for comparing and making informed choices among different institutions and financial instruments. The disclosure acts also serve to protect borrowers from abusive practices and make them more aware of the costs and commitments in financial contracts. A second purpose of consumer protection legislation is to ensure equal treatment and equal access to credit among all financial customers. The equal treatment acts can be viewed as the financial industry's counterpart to civil rights legislation aimed at ensuring equal treatment in such areas as housing, employment, and education. Other purposes associated with consumer protection include promoting financial privacy and preventing problems and abusive practices during credit transactions, debt collections, and reporting of personal credit histories.
Consumer protection objectives are generally consistent with good banking principles. In fact, credit and deposit disclosures and informed customers should be of most benefit to bankers offering competitive services. Likewise, equal and nondiscriminatory treatment of borrowers is necessary for any banker aiming to maximize profits. The growing complexity of financial instruments and the uniqueness of individual customers, though, have made consumer protection a very complicated and detailed regulatory process.

5.1.5 Is Not Intended To Accomplish

Because bank regulation has been extended to cover a range of goals, there is always the possibility that it might be extended to areas that are not a proper concern for public policy. Thus, the limits of bank regulation can best be understood in terms of the things it should not try to do.
Is it the purpose of banking regulation, for example, to keep banks from failing? Provided insured depositors can be protected and adequate banking services can be maintained, preventing the failure of individual banks is not a primary focus of banking regulation. In cases where banks are failing, regulatory aid might serve only to protect those responsible for the bank's poor performance- its management and stockholders. Furthermore, in a dynamic banking system, regulation cannot prevent all banking failures, at least not at an acceptable cost. Even if failures could be prevented, the result would be to sacrifice some of the main objectives of regulation. For example, poorly managed banks and their stockholders might have to be protected from competition and the discipline of the marketplace, thus giving them further incentives to take excessive risks and avoid corrective actions. Such protection might also leave the customers of these banks with overpriced, low-quality services. Finally, to prevent failures, regulators might have to impose tight restrictions on the entire banking industry, thus keeping well-managed banks from fully meeting the needs of their customers.

For the most part, the bank regulatory agencies have handled banking problems and failures with little disruption to depositors, other bank customers, and the local economy. Our deposit insurance system, for instance, has been able to protect most depositors at failed banks with such means as assumption of deposits by another bank or insured deposit payoffs or transfers. Through these actions, failing banks and their management and stockholders can be forced to bear the full consequences of their actions, and the deposits and many of the assets at these banks can be taken over by banks operated in a safer and more efficient manner.

Should bank regulation try to substitute government decisions for a banker's decisions in operating a bank? When bank examiners identify problems at banks, they may offer advice on how the problems could be corrected. The examiner is not in a position, however, to determine policy at a bank or to establish particular lending and investment practices. In fact, bank supervisors can often judge a banker's decisions only in retrospect. Credit decisions, for instance, might be based partly on characteristics of individual borrowers that only the lending officer understands. Also, a bank supervisor or examiner who spends only a few days or weeks in a bank cannot gather all the information available to the banker or fully comprehend all the policy decisions made in the bank. In meeting their own objectives, bank examiners and regulators must therefore be careful not to hinder banks as they serve the needs of their customers and the overall economy.
Should banking regulations and government policies favor certain groups over others? This kind of intervention in banking, except in cases of obvious distortions, is not desirable for several reasons. In a free society, market forces should be free to allocate credit and resources. Rules that interfere with the market are inconsistent with this principle and may have unforeseen side effects. Any such intervention in banking is often likely to be futile, or nearly so, since borrowers and other customers can frequently shift their business into "favored" areas or switch to less regulated entities.

Consequently, banking regulation must be evenhanded in its effects on various groups. Regulation should not give preferential treatment to financial institutions or to their customers, and it should not favor one size or type of financial institution over another. For example, banks should not be protected from the competition of other institutions — nor other institutions from bank competition. In the interest

of a competitive and efficient banking system, good bank regulation should have minimal effects on credit and resource allocation decisions and should not encourage costly efforts at circumvention.

5.2 Regulation of Insurance Companies

The regulation of insurance serves as a strong signal of its importance to the overall economic well being of our society and to the members within this society. It is vitally important that the insurance industry operates in a sound fashion and that it has the capacity and the willingness to pay claims. As we all know, banking also is regulated for the same reasons.

When you open an account at the bank, the bank accepts the cash and in turn provides you with a promise to hold this money for a period of time. It then returns it to you along with any interest that was earned on this money. From an accounting perspective, the bank treats the receipt of cash as an asset and the promise to pay the depositor as a liability. Likewise, the insurer collects premium payments from its insureds and in return, provides a promise to pay in the event of a covered loss. The contract periods can be short-term in nature (e.g., six months) or in the case of some life insurance products; it can be very long-term in nature. Regardless of the potential length of the contract, it is important that the insurer has the financial capacity to pay claims. Additionally, it is important that the insurers operate in good faith and as such, pay claims in timely and fair fashion.

All of the following are examples of areas over which insurance regulators have some type of oversight responsibility:

- insurer solvency
- market practices
- policy forms
- market conduct to include licensing and discipline of agents
- premiums (fair and adequate)

5.2.1 Insurer Solvency

While this list is not necessarily in order of priority, insurance regulators are most concerned with insurer solvency. Tools that the regulator uses to monitor insurer solvency include company audits, Financial Analysis Solvency Tools (FAST) System, and risk-based capital (RBC) requirements.

5.2.2 Market Practices/Conduct

The regulator also is tasked with "protecting" the consumer from the insurer. In this setting, we do not use the protecting to portray insurers in a negative light. If you took a survey of all of the people that you know, I think that you will quickly find that most people will say that insurance is a product that they just don't understand. In fact, I think at times that we must have that phrase hardwired into our genetic code! Whether this is due to the complexity of the process and contracts or is just a result of their unwillingness to educate themselves about insurance, these consumers are at a disadvantage in the marketplace. The insurance regulator provides support for them by regulating the content of insurance contracts, providing price and availability information, and protecting consumers from unethical companies and insurance agents. We should note here that regulation does impose a significant cost on the system. The cost that insurers incur to satisfy solvency requirements and to pay the costs of regulatory oversight is real costs that ultimately must be transferred to the consumer as

part of the premium. Your authors use the term agency costs to refer to the costs incurred to manage or reduce an inherent conflict between parties to contracts. In a world without regulators, the insurer would be in a position of having vastly superior knowledge of the contracts and the incentives to operate against the best interest of the consumer.

5.2.3 Policy Forms

Insurers must gain regulatory approval for new policy forms. The purpose of regulatory oversight in this area also is to protect the interest of consumers. As noted above, the complexity of insurance contracts creates the possibility that consumers could purchase contracts that contain unfair or deceptive provisions. The regulator helps to reduce this type of problem because it uses its technical expertise and knowledge on behalf of the consumer. Please note that the vast majority of insurers operate in a fair and ethical fashion. Given that, someone somewhere falls victim to misleading or deceptive practices every day, the insurance regulator provides a valuable service by protecting insurance consumers. Problems may arise from unfair and deceptive practices **following a loss**, but at least the contracts themselves should be fairly written.

5.2.4 Fair and Adequate Premiums

If you were to mention to the average consumer that one of the responsibilities of the regulator is to ensure fair and adequate premiums, they would probably wonder why regulators would care if an insurer charged a premium that was inadequate. They would argue that if the insurer did not charge sufficient premium, then that insurer should bear the consequences of underpricing its coverage. While this argument has its merits, the larger question is what happens to the remaining insureds if the insurer were to fail due to under-pricing? One solution would be that these people would have no coverage because the insurer that they purchased coverage from is no longer in a position to pay claims. That solution does not build overwhelming confidence in the insurance system. Most states operate under an **assessment system** where insurance companies that operate in that state are assessed to pay for the failure of an insurer. That way, claims can be paid and the insureds of the insolvent company are not forced to bear the entire burden of the failure. The presence of a safety net (in this case the assessment system) can lead to some insurers operating in an unsound manner by being overly aggressive in its pricing. If they succeed (i.e., losses are lower than expectations) then they end up with more market share because more people buy the lower priced insurance. If the insurer fails, then the costs are borne by the rest of the insurers. This scenario should sound somewhat familiar because behavior has changed due to the presence of the safety net. This is another example of the moral hazard problem that we discussed last week. By working to ensure premium adequacy, the regulator helps to reduce the moral hazard problem and reduce insolvencies. If the insurer is to satisfy its obligation to all of its policyholders, then it should charge a premium that is sufficient to cover its expected losses.

In general, regulators want to ensure that insurance companies honor their financial obligation to policyholders. Under-pricing policies could have series consequence-insurance companies can broke-trouble. Failure of big insurance company may lead to insurance run. To this end, regulations typically require insurance companies to (i) Disclose the components of their portfolios (in order to reduce policyholders' information costs about the solvency of insurers); (ii) Submit to examination to minimize fraud; (iii) Restrict holdings of risky assets; (iv) Limit premiums.