

Chapter Four

Bank Regulation

4.1 Introduction

Banking regulation in its strictest sense refers to the framework of laws and rules under which banks operate. Banking regulation has been an important factor in establishing the role of banks within the financial system. Banking and the regulation of banks are both key elements in the development of a country and its financial system.

There is a long tradition of regulating banks and securities markets in many countries. The primary justification for bank regulation that is usually given is the avoidance of systemic risk, or in other words, the *avoidance of financial crises*. Others are for the achievement of broader *social* objectives.

There are many reasons to study banking regulation and supervision, but two general objectives stand out. One is practical: people conduct transactions through the financial system and deal with banks on a frequent basis. Some knowledge of bank regulations is helpful in carrying out these transactions, understanding how the banking system works, and judging the extent of regulatory protection being provided. Moreover, an understanding of banking regulation has assumed added importance with the growing complexity of the financial system and the recent passage of major banking legislation.

The other major reason for studying banking regulation is to *ensure that this regulation both protects the public and fosters an efficient, competitive banking system*. The actual benefits and costs of banking regulation, in fact, are a concern of many different groups. This attention originates from a number of factors, including the overall importance of the banking industry to the economy and the financial problems encountered by some bank and thrift organizations in past years. Another concern is whether credit and other banking services flow evenly to different segments of the population. In addition, some contend that banking regulation may impose excessive cost burdens that hinder banks in providing services to their customers and in competing with other financial institutions.

The benefits and costs of banking regulation are also drawing attention because of many recent industry changes, such as electronic and internet banking, improved communications and data processing systems, and the development of new and more complex financial instruments and risk management practices. These revolutionary, technological changes are bringing banking closer to its customers, altering the way financial transactions and banking operations are conducted, and expanding the variety of services banks can provide.

All of these factors are prompting much debate over the appropriate regulatory framework for banks and the types of financial services banks should be able to offer.

4.2 Why Regulate Banks

Commercial banks are regulated and supervised at both the federal and state levels. Unlike other types of business firms, banks require *special charters* from either the federal or state governments.

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.

The following sections focus on several of the more *commonly accepted goals* of bank regulation.

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 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.

In summary, bank depositors may have more difficulty in 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.

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.

National bank has responsibility for controlling the overall volume of money circulating throughout the economy and thus for providing a stable base for 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.

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.

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.

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.

4.3 Bank Regulatory Structure (Instruments)

To maintain the health of the financial system governments have developed a whole range of regulatory instruments. They have placed different degrees of emphasis upon the various objectives at different times and have used different regulatory tools to achieve them.

First, public authorities may limit themselves to *ex-post interventions*, offering protection to customers and financial intermediaries in the case of *impending insolvency*. They may also act in a *preventive* way by controlling the levels of risk assumed and reducing the probability of insolvency and illiquidity.

Second, the safety and stability of the financial system may be enhanced by *structural limitations of competition and market forces*. Instead of these structural measures more weight is given to market efficiency by resorting to a whole set of prudential measures.

Third, regulatory measures may focus on the *macroeconomic concerns of systemic risk*, or directly aim at microeconomic consumer protection. However, both are interrelated as the avoidance of consumer risks also limits systemic risks and vice-versa.

Historically, the overriding reason for government intervention has been the desire to avoid systemic risk, mainly by *ex-post* rescue operations of financial intermediaries. Preventive measures were mostly of a structural nature by *limiting competition*. The focus on market efficiency and individual consumer protection by deposit insurance and prudential measures is of a more recent date.

There are three instruments of regulation: *Structural (or Systemic) regulation*, *Prudential regulation*, and *Conduct of business regulation*.

A) Structural (or Systemic) Regulation:

In order to limit the threat of systemic risks government intervention in the financial sector traditionally consisted in regulatory measures aiming at *limiting competition*

and at *restricting the operation of market forces*. Uncontrolled competition was seen as a major threat to the stability of the financial sector.

Structural regulation mainly involves restrictions on *entry and on business activities*, and often includes various measures of interest rate regulation. This regulation is concerned mainly with the *safety and soundness* of the financial system.

It was mainly in the aftermath of the Great Depression, which found its origin in a stock market crash, that it was deemed necessary to introduce *structural restrictions* on the scope of *permissible activities* of the different financial institutions. Frequently the ownership of financial institutions and non-financial firms was separated, and the investments of industrial firms in banks limited. However, these additional restrictions were aimed at limiting the concentration of power. For similar reasons also *branching restrictions* could be imposed.

Interest rates are important instruments of monetary policy. Hence, governments traditionally have intervened in the price formation in money and capital markets by regulating interest rates. *Interest rate ceilings* and other pricing rules, however, were also introduced to limit competition between banks and other financial institutions. Limiting price competition in financial markets would also reduce risk taking and moral hazard problems for financial institutions. Imposing interest rate ceilings would lower the cost of funds, enhance profits and reduce the likelihood of bank runs. Various regulatory instruments are used, mainly:

- Restrictions on entry and on business activities
- product line restrictions
- geographic restrictions
- Regulation of interest rates
- Branching restrictions
- Interstate banking activity restrictions

B) Prudential Regulation:

Prudential control is exercised first at the market entry stage by '*chartering*', which is the obligation to file an application for a charter. To obtain a *license* the owners have to supply sufficient equity capital. A minimum of capital is required as a cushion against losses. The chartering of new financial institutions is also subject to a screening of the proposed managers to prevent undesirable people from controlling them. According to Mishkin (1997) an adverse selection problem arises as financial activities may attract entrepreneurs wishing to engage in speculative activities.

A central instrument of prudential control consists in *capital adequacy* rules. Equity capital provides the necessary cushion against losses, since shareholders may want to benefit from the leverage effect and to increase their return on equity by providing as little capital as necessary. Only in well capitalized institutions, however, do the shareholders have enough incentives to monitor their financial health. When financial institutions hold a large amount of equity capital, they have more to lose in case of failure so that they will pursue less risky activities.

Besides structural interventions whereby financial institutions are not allowed to engage in certain activities, such as investments in common stocks by banks, the imposition of quantitative limits on certain asset holdings has more the character of prudential regulation. By '*portfolio diversification rules*', such as limiting the amount

of loans in particular categories or to individual borrowers, the risk profile of banks can be reduced. *Cash reserve requirements* are often imposed as a measure to enhance liquidity adequacy.

By regular *examination* and *inspection* regulators may limit the moral hazard problems. Recent prudential measures such as '*disclosure requirements*' tend to emphasize the disciplining of financial institutions by the market rather than by regulators. Generally, providing appropriate and timely disclosure of financial conditions of companies may help to reduce stock price volatility and excessive speculation. In particular, disclosure of financial conditions of financial institutions not only increases the ability but also gives incentives to investors to monitor the performance and the risk-profile of financial intermediaries.

This regulation is concerned mainly with consumer protection. Prudential regulation inhibits banks from providing long-term financing. Regulation is prudential when it is aimed specifically at protecting the financial system as a whole as well as protecting the safety of small deposits in individual institutions. Various regulatory instruments are used, mainly:

- Portfolio restrictions and supervision
- Capital adequacy standards
- Asset restrictions and diversification rules
- Liquidity adequacy requirements
- Disclosure standards and reporting requirements
- Conduct and conflict rules
- Inspection and bank examination

C) Conduct of Business Regulation:

This regulation focuses on *how banks* and other financial institutions *conduct* their business:

- It relates to information disclosure, fair business practices, competence, etc.
- It focuses on establishing rules to minimize the risk that:
 - o Consumers receive bad advice
 - o Frauds and misrepresentation
 - o Employees and financial advisor act incompetently

Structural and prudential regulation often involve a whole set of different public regulatory measures which differ from country to country. Protective interventions in the form of the lender of last resort and deposit insurance provisions do not involve such extensive regulation. Central banks can significantly limit the occurrence of systemic crises by their role as a 'lender of last resort'. Central banks have been set up to control liquidity provision in the economy. They are the ultimate source of credit to which financial institutions can turn during a panic. By providing liquidity as a bankers' bank they can stop the contagious transmission of financial problems among financial intermediaries.

It follows from the previous discussion that the need for government intervention as well as the choice of regulatory instruments depends on the *threat of the occurrence* of systemic crises and on the need for individual investors' protection. The occurrence of these risks may differ among financial institutions. Hence, the need for

regulating the different types of financial institutions depends on the specific activities they engage in. In particular the danger of systemic risk is seen as justifying a larger role for government. In this respect the activities of the different financial institutions may be compared according to three criteria: *first* the risks involved that may lead to their failure; *second* the interconnections among intermediaries determining the contagion affect; and *finally* their importance for the whole financial system and the real economy.

4.4 Methods used by Regulators to Monitor Commercial Banks

Regulatory agencies not only supervise the internal operations of commercial banks, but also make decisions affecting the number of banks, their ability to expand, and their permissible activities. Banking crises, rapid structural change, and the continuing globalization of banking have led national and multilateral policy makers to focus increased attention on the crucial role of banking supervision.

The way in which the supervisory authorities supervise banks is quite important. Indeed, unless these authorities appropriately interpret and enforce the regulations governing banks, the regulations themselves become meaningless. Perhaps more importantly, it is the supervisors who have direct contact with the banks and therefore represent the main line of defense against unsafe and unsound banking practices.

Supervisory authorities therefore seek to detect and assess activities and practices that expose banks to excessive risk relative their level of capital, and to require banks to appropriately manage their risk exposures.

The following section provides the methods used by regulators to monitor commercial banks as per the aforementioned goals of bank regulation.

4.1.1 Regulation for Depositor Protection and Monetary Stability

As we discussed in the above about the objectives of regulating banks, depositor protection and monetary stability can depend on many factors other than the deposit activities of banks. Few of the assets backing bank deposits, for instance, can be considered riskless, and virtually all bank operations entail some potential exposure to loss. In addition, since a notable portion of bank deposits are available on demand, bank liquidity can be an important factor in maintaining depositor confidence. Given these complexities, it is not too surprising that several different approaches are commonly used to protect depositors. These include restrictions on bank risk taking, a deposit insurance system funded through premiums paid by banks, and the federal government's assumption of overall responsibility for monetary stability and depositor protection.

Banking regulators first seek to restrict bank risk taking as a means of limiting individual bank failures and depositor losses, as well as preventing banking panics. With the advent of deposit insurance, control of banking risks also became a way of limiting claims on the deposit insurance fund and thus making deposit insurance a workable system. Some of the methods now used by bank regulators to control banking risks are *bank capital requirements*, *restrictions on the type and quality of bank securities holdings*, *periodic examinations* of loan quality and other banking factors, limitations on the activities that banks and their employees can pursue, and supervisory enforcement actions to control risk taking at problem institutions.

These efforts to control banking risk are an essential element in today's banking system and in the protection of depositors. Such controls must be sufficient to limit bank risk taking to a level consistent with depositor interests, overall financial stability, and the continued operation of the deposit insurance system. At the same time, though, this regulatory approach must not be too restrictive if banks are to meet the needs of their customers, compete effectively with other financial institutions, and adapt to a changing financial system. Banks, in fact, cannot avoid taking risks in their everyday operations. They must design services in anticipation of both customer needs and economic trends, make decisions on the creditworthiness of borrowers and their ability to repay debts in the future, and enter into many complex financial transactions. As a result, regulatory controls on bank risk taking must establish prudential bounds on banking activities without needlessly restricting normal banking functions.

Regulatory and supervisory standards address the types and quality of assets banks can hold. This policy is implemented in two ways: (1) permissible banking assets are defined; and (2) regular examinations and other supervisory procedures are used both to check compliance with the statutes and to review a bank's loan and investment policies and the quality of its assets.

Some of the Banking Factors and Regulations affecting Depositor Safety are discussed below:

The role bank regulators assume in protecting and insuring depositors is similar to the position any creditor or insurer takes in protecting his or her interests. A bank regulator has much the same concerns as any creditor and takes much the same steps. Creditors

try, for example, to limit a borrower's risk or charge more for higher risks. Creditors also try to limit their own exposure and increase a borrower's stake in the transaction by securing collateral for the loans they make and by limiting a borrower's indebtedness relative to his or her income and resources. A creditor may also want to impose restrictions on a borrower's activities and use of assets and undertake periodic investigations of the borrower's operations.

Bank regulators take many similar steps in an effort to control banking risks and thereby protect depositors and ensure financial stability. Banks, for instance, are restricted to certain activities and must maintain adequate capital relative to asset and operational risks. They are also expected to maintain enough low-risk liquid securities to cover normal fluctuations in deposits. They are regularly examined, and bank supervisors will impose tighter restrictions on banks if their condition declines.

Several other regulations, such as bank entry restrictions and supervisory review of ownership and management changes, affect depositors and banking risks. Since these regulations have a substantial effect on banking competition and efficiency, they are discussed in the next section.

a) General Lending and Investment Restrictions

Although bankers must follow any state and federal credit statutes applying to lenders in general, only a few provisions restrict the types of loans they can make.

Instead, bank credit decisions are based primarily on business factors and the need to maintain a secure asset base and a sound reputation in order to support bank deposits. Periodic loan reviews by internal committees, independent auditors, and bank supervisors provide an additional check on bank credit quality. These are:

- i. Real estate loan restrictions-* this is to keep banks from carrying a concentration of long-term loans that could not be readily liquidated to meet depositor needs or quell a banking crisis. Real estate lending regulations attempt to limit excessively risky lending practices, while giving bankers flexibility to meet the needs of most borrowers.
- ii. Selective credit controls-* for example channeling credit and materials toward the current burning issue of the country (such as food security-related production).
- iii. Examination and supervisory influence on credit quality-* The major supervisory influence on the types, maturity, and quality of bank loans is through examination and supervision rather than through lending statutes. Bank loan portfolios are evaluated primarily with regard to their overall quality and their risk under different economic conditions. Since the majority of bank assets are typically loans, assessments of loan quality are central to an examination and to a determination of the protection provided bank depositors and the deposit insurance fund.
- iv. Limits on loans to a single borrower —* Bank lending decisions are affected not only by supervisory reviews and statutes relating to specific types of loans, but also by several general credit regulations.
- v. Loans to insiders —* another credit restriction applies to insider loans. The basic reason for insider lending restrictions is to prevent those in charge of a bank from using their positions to obtain credit on preferential terms and outside normal credit underwriting standards. Such restrictions help ensure that a bank's lending is in the best interest of its depositors and community.
- vi. Acceptable types and maturity distribution of securities —* to limit portfolio risks on investments and provide liquidity, banks are authorized to purchase and hold only certain types of debt securities.

b) Maintenance of Adequate Capital

A commercial bank must have enough capital to provide a cushion for absorbing possible loan losses or other problems, funds for its internal needs and expansion, and added security for depositors and the deposit insurance system. In addition, higher capital serves to increase the financial stake that stockholders have in the safe and sound operation of a bank. Consequently, bank regulators view capital as a key element in holding banking risks to an acceptable level.

c) Reserve requirements

Reserve requirements were originally adopted in banking systems as a liquidity measure to counter deposit drains or note conversions and to protect bank customers.

d) Deposit interest rate limitations for insured institutions

Interest rate ceilings on time and savings deposits and the interest rate prohibition on demand deposits may be legislated as a means of limiting interest rate competition among banks.

e) Supervisory Compliance Procedures

The principal supervisory procedures used to check compliance with banking regulations and protect depositors fall under the categories of bank examinations, bank holding company inspections, reporting requirements, surveillance systems, enforcement actions, assessments and policies. In addition to these supervisory procedures, many banks and holding companies must also submit an annual report to federal and state banking agencies containing annual financial statements, statements by bank management, and an independent public accountant's report. The framework used to develop an overall view of a bank and its ability to protect depositors are discussed below.

i) Bank Examinations

Bank examinations are used to collect on-the-spot information that will indicate the current financial condition of a bank and its compliance with applicable laws and regulations. Bank exams, though, do not serve as audits. Examiners confine themselves to evaluating only the activities and bank records that are necessary to judge a bank's condition and regulatory compliance. Generally, the scope of an examination is limited to the bank's records and does not include verifying the bank's entire asset and liability account balances.

Federal bank supervisors review six critical aspects of a bank's operations and condition in their examination rating procedure, commonly called the CAMELS rating system. The aspects are:

- **Capital adequacy**
- **Asset quality**
- **Management and administrative ability**
- **Earnings level and quality**
- **Liquidity level**
- **Sensitivity to market risk**

Banks are rated from '1' to '5' on each of these aspects. A '1' is the highest rating and indicates the strongest performance, best risk-management practices, and least degree of supervisory concern. On the other hand, a '5' is the lowest rating and implies the weakest performance, inadequate risk-management practices, and highest level of supervisory concern.

Capital ratings, for example, partly reflect how a bank's capital compares to the capital of other banks and to established capital standards. In rating capital at a particular bank, though, examiners assess whether the bank is maintaining capital commensurate with the nature and extent of risks it assumes and whether bank management has the ability to identify, measure, monitor, and control these risks. Among the individual factors examiners use to assess capital adequacy are the level and quality of capital; ability of management to address the need for additional capital; the nature, trend, and volume of problem assets; adequacy of loan loss allowances; balance-sheet composition and inherent risks; and risk of off balance sheet activities.

Asset quality ratings are determined by the amount of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, and other assets and off balance sheet transactions. In particular, examiners assess such factors as

the adequacy of a bank's loan underwriting standards and loan and investment policies; the volume and severity of problem, classified, and nonperforming assets; adequacy of loan loss allowances; and existence of asset concentrations and degree of diversification in the loan and investment portfolios.

Management ratings are assessed according to the capability of a bank's board of directors and management to identify and control the bank's risk exposure and to ensure safe, sound, and efficient banking operations in compliance with applicable laws and regulations. This capability is rated according to the level and quality of oversight the board of directors and management provides; ability to plan for and respond to emerging risks; and adequacy of internal policies, controls, audits, and information and risk-monitoring systems. Examiners also look at many other management aspects, including regulatory compliance, management succession plans, avoidance of self-dealing, willingness to serve the community, and the overall performance of the bank.

A *bank's earnings* rating is based on the level and trend of its earnings, adequacy of earnings for supplying internal capital and meeting possible loan losses, quality and sources of earnings, level of expenses, adequacy of budgeting and forecasting processes, and the exposure of earnings to various risks. In rating bank earnings, examiners typically compare a bank's returns to those of similar banks ("peer banks") in order to assess whether a bank is achieving above or below average profitability.

Liquidity is rated according to whether an institution can maintain a level of liquidity sufficient to meet its financial obligations in a timely manner, while fulfilling the banking needs of its community. Banks are expected to meet liquidity needs through such means as maintaining their deposit base, holding assets that are readily convertible into cash, having access to money markets and other funding sources, diversifying funding sources, securitizing assets, and following effective funds-management practices.

Ratings for a bank's *sensitivity* to market risk are based on the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices would adversely affect the bank's earnings or the value of its capital. Examiners further assess the ability of management to measure and control these exposures, as well as the nature and complexity of such risks.

ii) Reporting requirements

Banks must file various reports with their supervisors. Some reports, such as on insider loans, are used for specific regulatory objectives, while others inform bank supervisors of a bank's current condition and performance. Since the Report of Condition is a balance sheet of a bank, it is the basic report for supervisory purposes and provides the deposit information used for insurance assessments. Other reports are required for such purposes as calculating reserve requirements, and tracking changes in such areas as ownership and management structure, financial holding company activities, foreign lending exposures, and insider lending. In addition,

problem institutions may be asked by their primary supervisor to file special reports on their overall condition and progress in restoring capital or improving asset quality.

Most bank reports are also available to the public and serve to give investors and bank customers information on a bank's operations and performance.

iii) Surveillance and early warning systems

Federal bank supervisors use surveillance and early warning systems to monitor a bank's condition and performance between examinations and indicate when special examinations or emergency measures might be necessary. These surveillance systems are constructed primarily from previous examination information and the regular reports filed by banks.

iv) Enforcement actions and penalties

The federal banking agencies can initiate a number of enforcement actions and penalties to direct banks, holding companies, and their management to correct problems and prevent further deterioration. In general, the federal agency supervising the institution or company has the authority to pursue enforcement actions.

For banking problems that are not severe and do not involve abusive practices, federal banking agencies may pursue any one of several informal actions or voluntary agreements. These include verbal or written commitments by bank officials to resolve identified problems, board resolutions that record such commitments, and memoranda of understanding that reflect an agreement between a supervisory agency and a bank's directors. Because these actions represent voluntary agreements, they are generally used in cases where bank management can be expected to take the necessary corrective steps.

For more severe violations and unsafe or abusive practices, banking agencies can issue formal and legally enforceable actions. These actions encompass written agreements, cease and desist orders, and suspension, prohibition, or removal actions. These actions can be directed toward party not only includes bank directors, officers, employees, and controlling shareholders, but it can also extend to bank consultants, joint venture partners, and independent contractors for a bank, such as attorneys, appraisers, or accountants.

v) Annual independent audits and related reporting requirements

In addition to oversight by supervisory agencies, many banks also must be audited annually by independent public accountants. This audit requirement is intended to help banks identify problems at an early stage and to bring about more stringent internal controls and more accurate reporting.

These annual reports must be made available for public inspection and must contain three items. One item is an audited annual financial statement and the independent public accountant's report on this statement. A second item is a report and assessment by bank management on the effectiveness of the bank's internal controls and its procedures for complying with safety and soundness regulations. The final item is the public accountant's report evaluating the bank's internal control

structure and the assertions made by management. The financial statements must reflect generally accepted accounting principles.

4.1.2 Regulation Consistent with Efficient and Competitive Financial System

In addition to their responsibilities for depositor protection and monetary stability, bank regulatory agencies are responsible for promoting an efficient, competitive banking environment and preventing monopolization of individual banking markets. The performance and competitiveness of the banking industry is viewed as a critical element in fostering a healthy and dynamic economy. Furthermore, as banks compete more directly with nonbank institutions and as new financial instruments and markets are created, many questions are being raised about what parts of the financial industry require close supervision and how this oversight can be implemented without stifling innovation or burdening the regulated institutions.

Banking regulation can have a profound effect on competition and efficiency within the banking industry and throughout the financial system. Banking laws and regulations, for example, can influence bank entry and expansion, the products offered by banking organizations, the manner and cost of providing these products, and, in turn, the ability of banks to compete with other institutions. As a result, banking regulation must not only strive to protect depositors and maintain monetary stability, but must also foster active competition and innovation in financial markets.

a) Bank Ownership Regulations

A key reason bank ownership is of interest to banking regulators is because stockholders provide the financial support behind a bank. In addition, bank ownership changes can affect competition and public benefits. Through ownership or management relationships, for instance, an individual or group could control more than one bank in a market. While such expansion in a market could be used to create a more efficient and competitive banking organization, it could also be used to develop a monopolistic position in the market and thus decrease the overall level of competition. Consequently, federal legislation has given the banking agencies authority to examine both the financial and competitive issues associated with bank ownership and control.

b) Geographic Scope of Operations

Banking competition and efficiency are also influenced by the avenues that banks and bank holding companies have for expanding their operations geographically, such as branching, electronic banking, and international banking. Such avenues include additional branch offices, bank holding company acquisitions of banks and nonbanking firms, mergers with other institutions, and electronic or internet banking. Depending on state and federal laws, a banking organization might use these or other forms of expansion to extend its operations within a particular state, across state lines, or even into foreign countries.

c) Changes in the Competitive Marketplace

In past years, many bankers had viewed themselves as competing primarily with other bankers for customers, and they paid far less attention to other types of financial institutions.

Over the past few decades, this financial structure has changed significantly. Technological innovation, profit pressures, unmet customer needs, new financial instruments serving multiple purposes, and a changing regulatory framework have provided many market participants with the ability and the incentive to begin exploiting profitable opportunities in other sectors. Improvements in communications and information processing, for instance, have lowered the cost of obtaining financial information on prospective customers. These improvements have also allowed many new products to be created and marketed to a much wider audience, thus opening the door for companies to reach customers formerly served by other types of institutions.

Many households have increasingly turned away from the traditional savings account instruments offered by banks and thrifts to money market mutual funds, other types of mutual funds, and cash management accounts. A new competitive framework has emerged in the credit markets as well, such as Issuance of commercial paper.

4.1.3 Regulation for Consumer Protection

Consumer protection is a key part of banking regulation, and public interest in consumer protection laws has increased rapidly in response to the dramatic growth over the past few decades in consumer lending and other consumer banking relationships.

Consumer protection laws may be grouped into three general categories or objectives. Two can be classified broadly as disclosure laws and civil rights laws. The third category consists of laws designed to protect a consumer's privacy and provide safeguards against specific abuses in the extension, collection, and reporting of consumer credit.

4.2 Deregulation of Commercial Banks

Bank [deregulation](#) typically refers to the elimination, or simplification, of various laws that apply to banks. This concept is often promoted by free-market advocates. These proponents stress minimal, if any, interference by the government in the private sector. Usually bank deregulation, however, does not involve the elimination of laws against [fraud](#) and other criminal practices. And, deregulation does not mean absence of regulations. Deregulation merely reduces external regulation and substitutes them with internal prudential regulation norms.

Bank deregulation is closely associated with free-market economics. The primary concept of free-market economics is that limited governmental involvement in the market will allow the market to settle into an optimal state. Similarly, deregulation advocates believe that regulatory control restrains competition in the banking sector. According to this idea, competition will be economically beneficial to individual banks and consumer generally. In [theory](#), banks will be forced to offer the best deals to prospective customers, and manage their affairs efficiently and effectively, in order to remain in business.

The free-market concept is highly associated with one of its greatest advocates in history-Scottish economist Adam Smith. One of his most famous terms is "the invisible hand," which refers to the concept that no regulation actually has a hand, though invisible, in directing the market to an optimal state.

The success of bank deregulation is debatable. For example, [bank regulation](#) leading up to the Great Depression was minimal. For example, after the economic collapse of 1929, the US government increased regulation and even created an independent agency-the Federal Deposit Insurance Corporation (FDIC)-to oversee bank processes. The economic collapse was partly seen to have resulted from an artificially inflated market caused by unregulated banks using underwritten stocks.

Beginning in the 1980s, there was a general movement away from bank deregulation. Largely attributed to the Reagan administration's economic focus on free-market principles, this shift towards deregulation culminated with the [Gramm-Leach-Bliley Act](#) of 1999. The Gramm-Leach-Bliley Act, also known as the Financial Services Modernization Act of 1999, allowed banks to have more freedom in their economic practices, and led to the elimination of the traditional separation between [bank insurance](#) and bank investments. Some analysts trace the economic downturn of 2008 and the bankruptcy of various American banks to the Gramm-Leach-Bliley Act.

The debates over bank deregulation are ongoing. Those experts who believe in the infallibility of the market suggest that any regulation eliminates competitiveness, which in turn limits economic growth. Those economists and financial experts that support bank regulation continue to reference the historical economic collapses that resulted from an unregulated free market and the infinite greed of the business sector.

