Regulation in the Banking Business and Its Effects

Banks and bank-like financial institutions operating within the United States and within most other countries must deal with extensive regulation in the form of rules and laws enforced by federal and state agencies. These regulations cover and monitor all areas of their operations, service offerings, credit quality and quantity, capital position, and the manner in which they grow and expand their facilities. This regulatory climate is primarily designed to protect the public interest, to encourage savings and investment by establishing an environment of economic soundness and stability, and to provide the public adequate financial information and credit without discrimination.

Additionally, the actions of banks can have effects which reach far into the structure of an economy: they have the power to create money by making loans and investment through extending credit; they provide loans that support consumption and investment spending; and they have long had a functional involvement with government through collecting taxes, dispensing government payments and other operations which closely tie them into the economic climate and policy-making. Cushman, p. 133).

In the United States, banks are regulated through a dual banking system; they are governed at both the state and federal level. This was designed to give the states

significant control over banks, and also to ensure that banks would be treated fairly as they expanded their operations across state lines.

Regulatory agencies are responsible for gathering and evaluating the information necessary to assess the true financial condition of banks to protect the public against loss due to mismanagement, embezzlement or fraud through periodic examinations and/or audits. (Rose, p. 33).

The main regulatory agencies at the federal level are the Comptroller of the Currency, the Federal Reserve System and the Federal Deposit Insurance Corporation.

The Federal Reserve Board is responsible for regulating the activities of state-chartered banks that are members of the Federal Reserve System, bank holding companies, the U.S. operations of foreign banks, and Edge Act and Agreement corporations. The Board approves or denies applications for merger, acquisitions and changes in control by state member banks and bank holding companies and approves or denies applications for foreign operation of member banks. In addition, Congress selected the Federal Reserve to write regulations implementing a number of consumer protection laws such as truth in lending and equal credit opportunity. This has been an area of concern and compliance for BankBoston during its recent acquisition by Fleet Bank.

The Office of the Comptroller of the Currency (OCC) is the oldest federal banking regulatory agency. It has the authority to approve or deny applications for new national bank charters, for the establishment of branches, and for mergers of national banks. The principal supervisory tools of the OCC are on-site examination and ongoing analysis of national bank operations. The OCC issues rules and regulations concerning bank lending, bank investment, and other aspects of bank operations.

The Federal Deposit Insurance Corporation (FDIC) protects depositors of failed banks, promotes stability and maintains public confidence in the banking system. The FDIC directs two federal deposit insurance programs – the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). The basic insured amount for a depositor is $100,000 at each insured financial institution. The BIF has created an insurance fund through income from investments in U.S. Government securities and from annual assessments paid by all insured commercial banks, certain federal and state savings banks, and industrial banks. The FDIC has the authority to examine insured financial institutions either directly or in cooperation with state or other federal authorities.

The Department of Justice reviews and approves proposed bank mergers and holding company acquisitions based on their

effects on the competition and the economic environment of the community what would be reasonably affected, and file suit if significantly damage would result by proposed organizational changes. The merger of BankBoston and Fleet Bank is so large that it became necessary for Fleet to sell off $13 billion in deposits to satisfy anti-trust concerns. ("A Boston Banking Behemoth Is Born", Business Week, March 29, 1999). (Cushman, p. 139.)

Each of the 50 states has a banking supervisor, usually called the bank commissioner or the banking superintendent. They have the power to issue charters for new banks, supervise and regularly examine all state-chartered banks, and have the right to approve all applications of banks operating within state borders to form a holding company, acquire affiliates and subsidiaries, or establish branch offices.

Major banking laws passed since the civil war that impact regulation of banks because of the agencies or controls they have caused include the following:

- Establishment of the system to charter national banks through the Comptroller of the Currency;
- Establishment of the Federal Reserve System to control money and credit conditions to provide stability to the system and a nationwide network to

clear and collect checks and electronic transactions, (Federal Reserve Act (1913);

- Establishment of branch offices by national banks, (McFadden-Pepper Act, 1927);
- Establishment of the legally mandated separation of commercial and investment banking. (Banking Act of 1933 – Glass-Steagall Act).
- Establishment of approval for mergers and acquisitions of banks (Bank Merger act of 1960, 1966).

Significant regulatory constraints were also placed on the banks in consequence of the era of "social responsibility" in the 1960's through the 1980s.

In 1968, Congress passed the Consumer Credit Protection Act, known as "Truth in Lending", requiring banks and lenders clearly spell out consumers rights and obligations in loan agreements. In 1974, Congress passed the Equal Credit Opportunity act which would ensure that bank services be provided to the public without discrimination due to a customer's age, sex, national origin or religious affiliation, or because they were welfare recipients. In 1977, the Community Reinvestment Act prohibited U.S. banks from discrimination against a customer based on their location of residence. The Competitive Equality in Banking

Act (1987) and the Truth in Savings Act (1991), required banks to more fully disclose information on their deposit policies and true rates of return. (Rose, pp. 37-59.)

Economic Development initiatives assist communities in creating sustained approaches to economic viability. Regulations also require a bank be evaluated on its record of community development services, community development investments and community development lending. In 1999, Bank Boston was cited for corporate achievement in Employee and Community Relations and given the Ron Brown Award for Corporate Leadership, the only such presidential award. Examples of their efforts included providing advertising in community newspapers using targeted ethnic marketing, assigning Community Development Officers with cultural insights and multilingual skills to lead basic banking workshops and developing a specialized FCB small business lending group. Parkinson, p.59).

The social responsibility laws did much toward ensuring the rights of bank customers and the public, but each law passed had the effect of increasing bank-operating costs. Additional staff must ensure all areas of disclosure and compliance are addressed, full training and implementation throughout any bank's system must make sure that policies integrating regulations must be addressed.

On November 27, 1991, Congress passed a banking bill called the Federal Deposit Insurance Corporation Improvement Act. In this law, federal banking agencies were required to develop new standards for the banks regarding loan documentation, internal management controls, management information systems, growth in real estate loans, interest-rate risk exposure and salaries and benefits paid to bank employees; as well as make sure banks are not violating the new guidelines.

No one knows exactly what the costs imposed by various banking regulations are, in dollar amounts. The size of the burden is estimated to be somewhere between seven and seventeen billion dollars annually, not just to the banks directly, but to the governments which maintain the regulatory agencies. There are also the costs of salaries and related overheads, the proliferation of paperwork and the need for trade association lobbyists to monitor legislative and regulatory activity.

Compliance costs are the costs most relevant to a bank and its customers. Care must be taken to ensure marketing materials include full display of FDIC insurance information, as well as careful wording to comply with advertising requirements for any loan or product (Regulation Z, Truth in Lending). Advertising requirements of the Fair Housing Act must appear in all marketing, including

appropriate statements and/or symbols. The hiring of compliance officers and staff, the extensive paperwork and re-working of paperwork on loans and deposits; all must be passed on to shareholders and customers.

Non-banking financial providers are not subject to the same regulations and this gives them a significant advantage. There has since been a movement toward deregulation to help banks remain competitive with their less-regulated competitors in the financial services industry. Ever-expanding fields of membership for credit unions, deposit accounts, credit cards and other banking-type services offered by brokerage houses blur the lines between banks and non-banks. The fact that banks must carry a multi-billion dollar annual burden means that the cost structure can raise prices to a point at which a bank can no longer remain competitive. The cost of regulation combined with the tax advantages the competition enjoys is an issue currently affecting the financial management environment.

An issue addressed recently in the ABA Banking Journal ("If It Ain't Broke, Cannibalize It", September 1999), is that the banks are not only being forced to reinvent themselves in the face of with new technology and threats from leaner, meaner competition, but that they must do so within the framework of a regulated institution.

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