Why Regulate Banks?

Why is government regulation of banks necessary?

Goal: Sound money and banking—people will trust banks and checks.

Is there a greater need to regulate banking than any other industry?

Reduce Chance of Bankruptcy

A key motive for bank regulation is to reduce the chance of bankruptcy.

Regulation to prevent bank fraud is seen as important.

Since banks invest mostly using other people's money, banks have an incentive to speculate: "Heads I win, tails you lose." Profits accrue to the owners of the bank, whereas large losses are borne by others.

Are Banks Special?

Is this problem particular to banking?

Any firm might defraud its investors. Any firm might make risky investments, making repayment to lenders less likely. Perhaps a bank is more likely to defraud investors because its debt/equity ratio is so high.

However a private equity company shares this trait, when it buys a target company in a leveraged buyout. The private equity company puts up little money of its own. The target company takes on so much leverage that the original creditors will lose their investment if the target is not successful.

Adverse Selection and Moral Hazard

Some claim that adverse selection and moral hazard are a greater problem in banking than in most other industries.

Capital Requirement

A check on bank speculation is a high capital requirement. If the net worth of the bank is high, then a speculative bank is gambling primarily with the money of its owners, not the money of others. Apart from a gigantic loss, any loss is borne just by the owners.

Bank regulators do set capital requirements on banks. Banks typically resist capital requirements, because they like to gamble with someone else's money. A small net worth is sufficient to meet the regulatory capital requirement.

Matching of Assets and Liabilities

The matching of assets and liabilities makes a bank less risky, as any change in asset value may be offset by the same change in liability value.

Bank liabilities are debt, mostly short-term debt.

Short-term loans then make the bank less risky. Long-term loans make the bank more risky, and equity is very risky.

Restrictions on Loans and Investments

Bank regulations prohibit stock purchases by banks in the United States. Also, investment in bonds with a low credit rating may be prohibited.

Typically the bank is free to lend either long-term or short-term.

At present there is no restriction on speculation in derivatives.

Deposit Insurance

A key development was deposit insurance by the federal government (1934), to prevent bank runs.

Before deposit insurance, if the bank went bankrupt, then the depositor could lose the entire deposit. After deposit insurance, the loss would be borne by the government.

Either way, reducing the chance of bankruptcy does have value.

Deposit Insurance after 2008 Crisis

During the financial crisis, deposit insurance was increased, to prevent bank runs. The insurance was raised to $250,000 per account. For a non-interest bearing business checking account, the insurance became unlimited.

Moral Hazard from Deposit Insurance

Bank deposits (except very large deposits) are now insured by the federal government. If a bank goes bankrupt, the depositors lose nothing.

Deposit insurance creates a moral hazard, for both banks and their depositors: the existence of the insurance affects behavior. The bank has an incentive to speculate: “Heads I win, tails you lose.” Profits accrue to the owners, whereas large losses are covered by the government. The depositors are unconcerned whether the bank is sound and how it invests their deposits.

Bank Construction

Before deposit insurance, banks built grand structures, to convince potential depositors that the bank was safe.

Today many bank branches are insubstantial.

Deposit Insurance and Regulation

Since the existence of the deposit insurance affects behavior, regulatory restrictions on this behavior may be justified. Restrictions are needed to reduce losses by the government.

Instability in Banking

History shows that banking can be unstable, and the entire economy suffers.

In good times the ready availability of credit can lead to an unsustainable boom. In bad times the contraction of credit makes recession worse.

Excess Lending

When a bank makes a loan, it just credits the amount to the account of the borrower. The interest paid raises the bank's profit. Consequently the greater are the loans, the greater is the profit.

From this point of view, banks have an incentive to expand loans excessively.

Bank Crisis

The reverse happens in a bank crisis. Some banks go bankrupt. The banking sector contracts: bank loans and investments decline, and the money supply falls.

Adverse selection can be a factor in this contraction. In a sudden crisis, the balance sheet of a firm can change quickly. The banks may not know which borrowers are safe and which are risky. They reduce lending, and the economy contracts.

Bank Runs

Before deposit insurance, a bank crisis would cause bank runs, aggravating the crisis. Depositors would take their money from the bank because they feared they might lose it. Banks would keep excess reserves to protect against a run. Bank lending would contract.

Bank runs in the Great Depression led to the bank holiday (1933), when all banks were closed for one week, and only sound banks were allowed to reopen.

Summary

Deposit insurance was adopted in 1934, to eliminate bank runs.

However the moral hazard effect of deposit insurance increases bank speculation.

Higher capital requirements would reduce bank speculation. Banks oppose higher capital requirements, because leverage is profitable.