

Finance 4000

Money and Capital Markets

Eleventh class

- Administrative matters
 - The website is <http://www.DwyerEcon.com>
 - capital letters are for clarity
 - The final is May 7
 - Material for the rest of the semester
 - today 4/13/99 Chapters 15 and 16
 - 4/20/99 Chapters 20 and 21
 - 4/27/99 Chapter 22
 - We are skipping chapters 17, 18 and 19

- Thrifts
 - Savings and loan associations
 - Mutual savings banks
 - Credit unions
 - All are special-purpose banks
 - Not special-purpose commercial banks

- Savings and loan associations and Mutual savings banks
 - Savings and loan associations
 - Federal government charters
 - Mutual savings banks
 - State government charters in the Northeast
 - Similar institutions exist in many other states
 - Building societies
 - Building and loan associations
 - Historically had savings accounts and certificates of deposit
 - Historically made and held mortgage loans
 - Often mutual associations
 - Deposit insurance by some entity or other after 1934

- Credit unions
 - Originally for people with employment who had difficulty borrowing from commercial banks or setting up checking accounts
 - Credit unions started in the early 1900s when most people had no connection with banks
 - Credit unions were not started because commercial banks *exist to serve commerce, not the working class, because that is where the profits are* (Mishkin and Eakins, p. 390)
 - Why would banks not want to go into the business of dealing with typical workers in the early 1900s?
 - Characteristics
 - Mutual associations
 - Nonprofit
 - Common bond
 - Historically, employer related
 - Historically, volunteer labor

- Advantages and disadvantages compared to banks
 - Advantages
 - Often work closely with employer, which makes loss less likely
 - Liable to know the borrower personally
 - Nonprofit
 - Can have lower costs due to volunteer labor
 - Disadvantages
 - Lack of diversification of depositors and borrowers
 - Can have less professional labor
 - Diseconomies of scale
 - * Can be overcome partly by having several common bonds for one credit union
 - * Also by joint purchasing — trade associations

- Why are Banks Regulated?
 - Standard economic rationales for regulation -- “Consumer protection”
 - Externalities
 - Public goods
 - Additional or alternative rationale
 - Regulation may be designed to protect consumers rather than consumers
 - “Producer protection” rather than “consumer protection”
 - Increase profits of producers (banks) by
 - Restricting entry by others
 - Suppressing substitutes and promoting complements
 - Providing subsidies

- What are the regulations that apply to banking?
 - Entry
 - Branching
 - Types of branching
 - Unit banking
 - Limited-branch banking
 - Statewide branch banking
 - Nationwide branch banking
 - * without restrictions
 - * or with restrictions
 - National legal framework
 - McFadden Act of 1927
 - Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994
 - Federal Reserve System as lender of last resort
 - Deposit insurance
 - Supervision and regulation
 - Community Reinvestment Act

- Consumer protection explanations of regulation
 - Lender of last resort and Deposit insurance
 - due to banking panics which have external effects
 - adverse effects on the economy
 - possible externality in banking panics themselves
 - Supervision and regulation
 - Prevent fraud
 - Prevent opportunistic, risky behavior given deposit insurance
 - Use regulation rather than prices to induce optimal risk-taking behavior
 - Implicitly taking improper pricing for deposit insurance as given

- Entry
 - Given deposit insurance and its pricing, prevent entry by those who would be more expensive to regulate
 - That is, those who would engage in riskier activities
- Branching
 - Empirical evidence indicates that branching restrictions are loosened when banking failures occur and new entry is not that likely
 - This indicates that branching restrictions are changed in response to costs imposed on consumers
- Community Reinvestment Act
 - Banks invest less than the optimal amount in some areas because of a lack of information
 - Regulation can induce them to provide more loans in these areas

- Producer Protection explanation of regulation
 - Entry restriction
 - Reduce competition
 - Branching restriction
 - Reduce competition
 - Some transfer from larger to smaller institutions

- Lender of last resort and Deposit insurance
 - As exist today, subsidies to banks
 - Possibly some transfer from smaller to larger banks
 - Too big to fail
 - prompt, corrective action
 - Banks can fail in banking panics
 - Banks are better off if they don't fail under such circumstances
- Supervision and regulation
 - Auditing services
- Community Reinvestment Act
 - A transfer of some of the banks' economic rents to people outside the industry
 - A payoff in exchange for the regulation