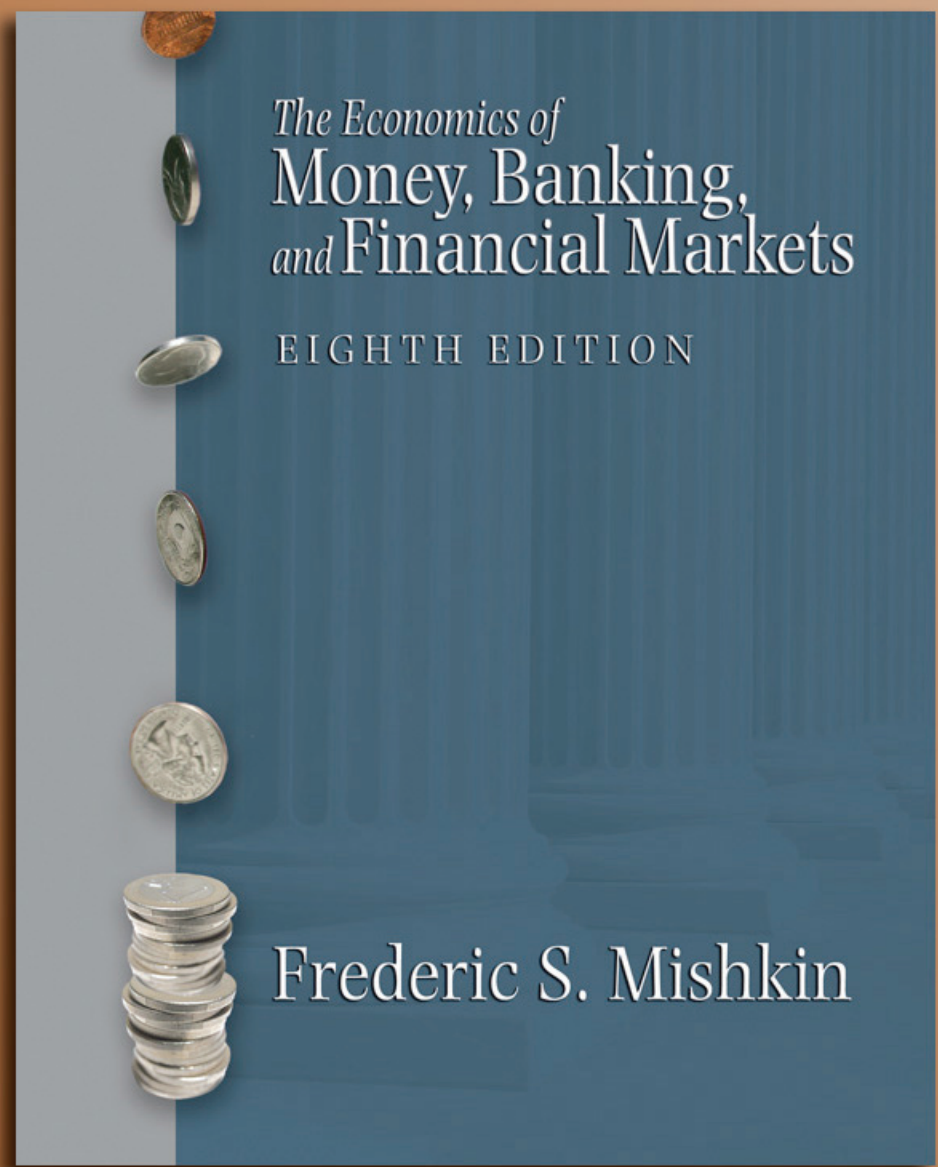

Chapter 10

Banking Industry: Structure and Competition

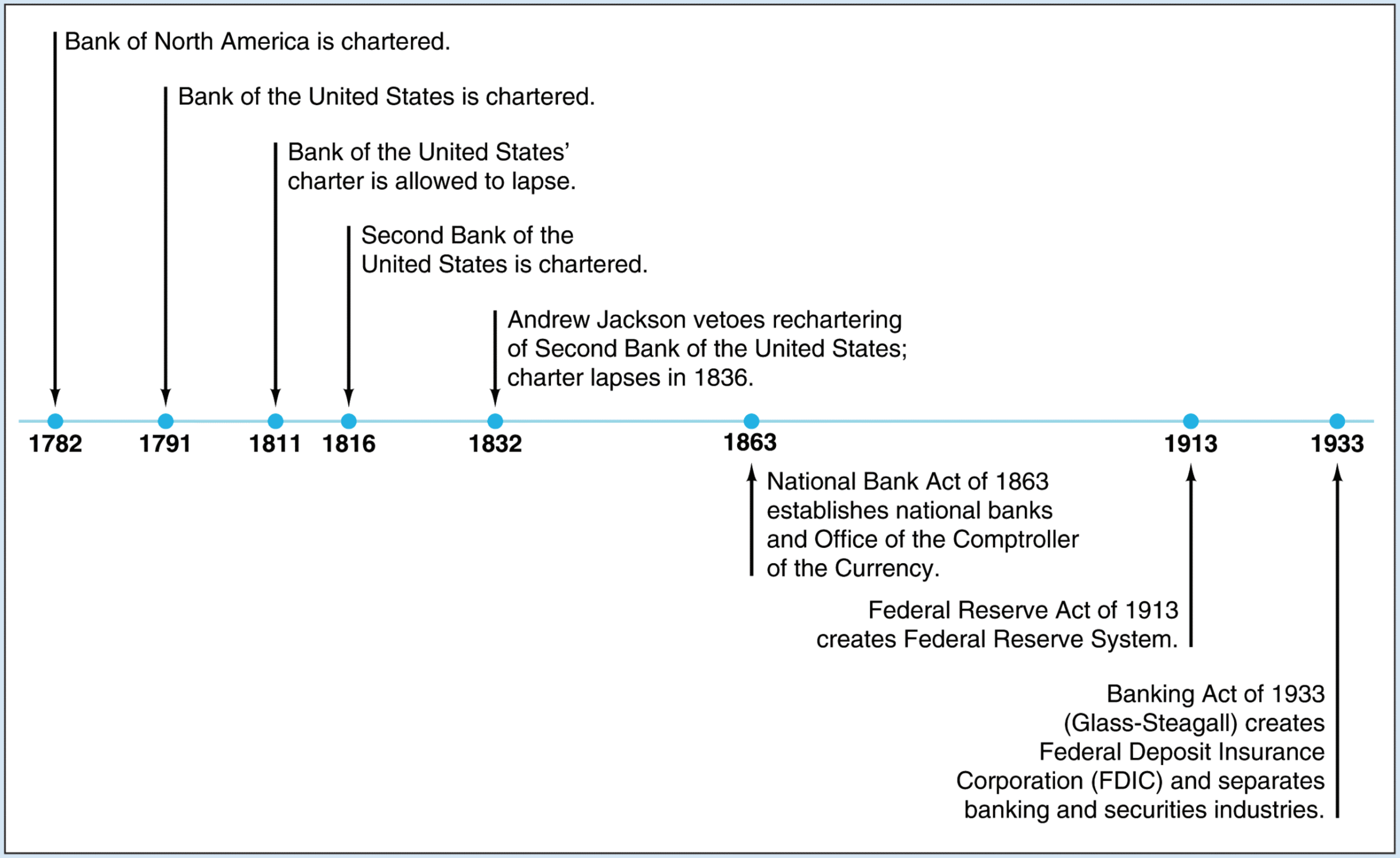

FIGURE 1 Time Line of the Early History of Commercial Banking in the United States

Evolution of the Banking Industry

- Financial innovation is driven by the desire to earn profits
- A change in the financial environment will stimulate a search by financial institutions for innovations that are likely to be profitable
  - Responses to change in demand conditions
  - Responses to changes in supply conditions
  - Avoidance of regulations

U.S. Has a Dual Banking System

- State banks chartered by state governments
- National banks chartered by federal government beginning in 1863

Primary Supervisory Responsibility of Bank Regulatory Agencies

- Comptroller of the Currency—national banks
- Federal Reserve and state banking authorities—state banks that are members of the Federal Reserve System
- Fed also regulates bank holding companies
- FDIC—insured state banks that are not Fed members
- State banking authorities—state banks without FDIC insurance

Responses to Changes in Demand Conditions: Interest Rate Volatility

- Adjustable-rate mortgages
  - Flexible interest rates keep profits high when rates rise
  - Lower initial interest rates make them attractive to home buyers
- Financial Derivatives
  - Ability to hedge interest rate risk
  - Payoffs are linked to previously issued securities

Responses to Changes in Supply Conditions: Information Technology

- Bank credit and debit cards
  - Improved computer technology lowers the transaction costs
- Electronic banking
  - ATM
  - Home banking
  - ABM
  - Virtual banking
- Junk bonds
- Commercial paper market
- Securitization

Avoidance of Regulations: Loophole Mining

- Reserve requirements act as a tax on deposits
  - Sweep accounts
- Restrictions on interest paid on deposits led to disintermediation
  - Money market mutual funds

Decline of Traditional Banking

- As a source of funds for borrowers, market share has fallen
- Share of total financial intermediary assets has fallen
- No decline in overall profitability
- Increase in income from off-balance-sheet activities

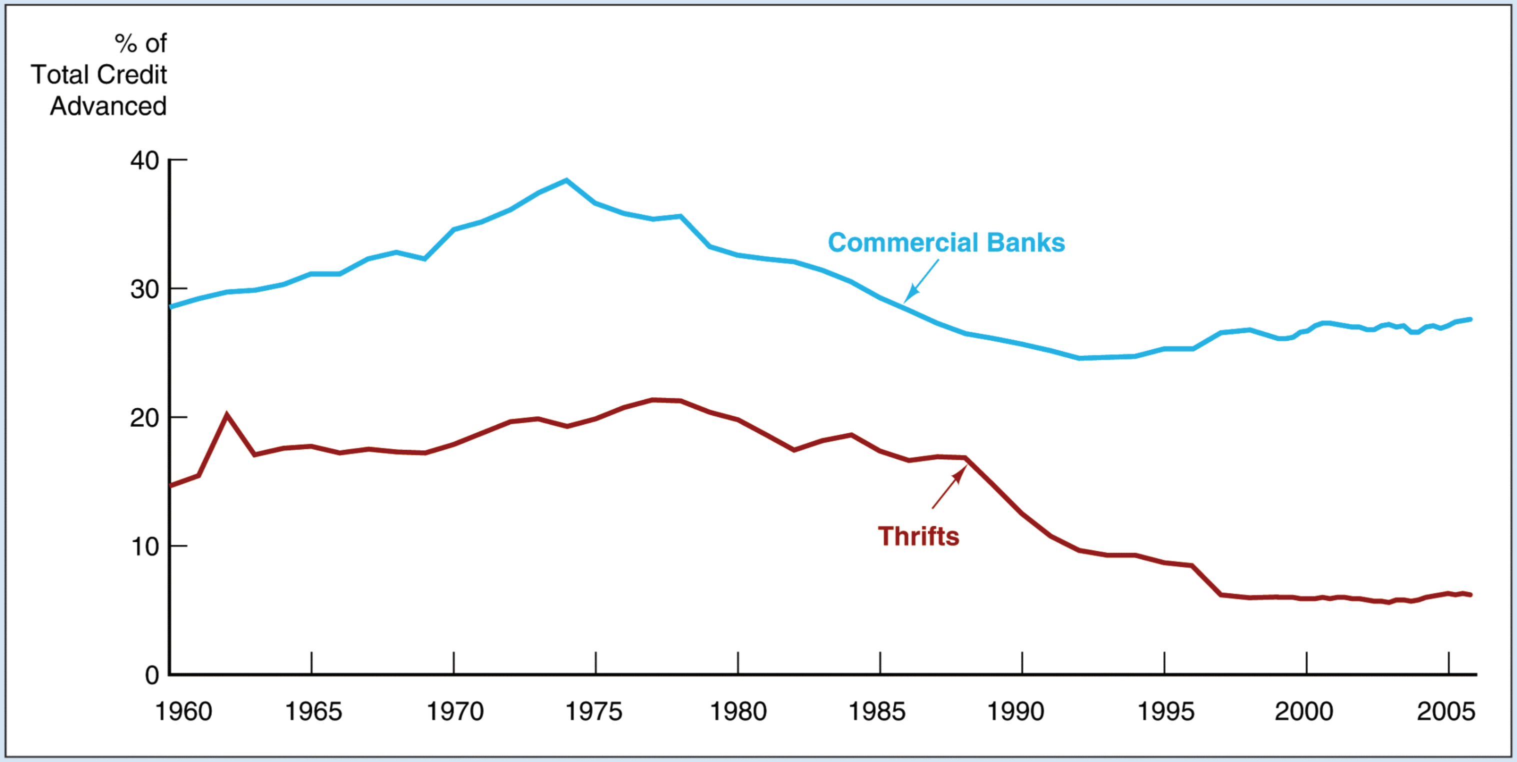

FIGURE 2 **Bank Share of Total Nonfinancial Borrowing, 1960–2005**

Source: Federal Reserve Flow of Funds Accounts; Federal Reserve Bulletin.

Decline of Traditional Banking

- Decline in cost advantages in acquiring funds (liabilities)
  - Rising inflation led to rise in interest rates and disintermediation
  - Low-cost source of funds, checkable deposits, declined in importance
- Decline in income advantages on uses of funds (assets)
  - Information technology has decreased need for banks to finance short-term credit needs or to issue loans
  - Information technology has lowered transaction costs for other financial institutions, increasing competition

Banks' Responses

- Expand into new and riskier areas of lending
  - Commercial real estate loans
  - Leveraged buyouts
  - Corporate takeovers
- Pursue off-balance-sheet activities
  - Non-interest income
  - Concerns about risk

TABLE 1 **Size Distribution of Insured Commercial Banks, September 30, 2005**

Assets	Number of Banks	Share of Banks (%)	Share of Assets Held (%)
Less than $100 million	3,523	46.72	1.92
$100 million–$1 billion	3,552	47.10	11.45
$1 billion–$10 billion	380	5.04	12.76
More than $10 billion	86	1.14	73.86
Total	7,541	100.00	100.00

Source: www2.fdic.gov/SDI/SOB/.

TABLE 2 Ten Largest U.S. Banks, September 30, 2005

Bank	Assets ($ millions)	Share of All Commercial Bank Assets (%)
1. Bank of America Corp., Charlotte, NC	1,057,298	12.19
2. J. P. Morgan Chase, Columbus, OH	1,008,426	11.63
3. Citibank, New York, NY	704,616	8.12
4. Wachovia Corp., Charlotte, NC	477,994	5.51
5. Wells Fargo, Sioux Falls, SD	380,109	4.38
6. U.S. Bancorp, Cincinnati, OH	206,667	2.38
7. SunTrust Bank, Atlanta, GA	170,774	1.97
8. HSBC Bank US, Wilmington, DE	145,949	1.68
9. State Street B & T Corp., Boston, MA	91,404	1.05
10. Keybank, Cleveland, OH	87,574	1.01
Total	4,330,811	49.93

Source: www.federalreserve.gov/releases/lbr/current/default.htm.

Branching

- McFadden Act and state branching regulations prohibited branching across state lines and forced all national banks to conform to the branching regulations of the state in which they were located
- Bank holding companies and automated teller machines are responses to these regulations

Bank Consolidation

- The number of banks has declined over the last 25 years
  - Bank failures
  - Consolidation
  - Deregulation—Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994
  - Economies of scale and scope from information technology
- Results may be not only a smaller number of banks but a shift in assets to much larger banks

Benefits and Costs of Bank Consolidation

- Benefits
  - Increased competition, driving inefficient banks out of business
  - Increased efficiency also from economies of scale and scope
  - Lower probability of bank failure from more diversified portfolios
- Costs
  - Elimination of community banks may lead to less lending to small business
  - Banks expanding into new areas may take increased risks and fail

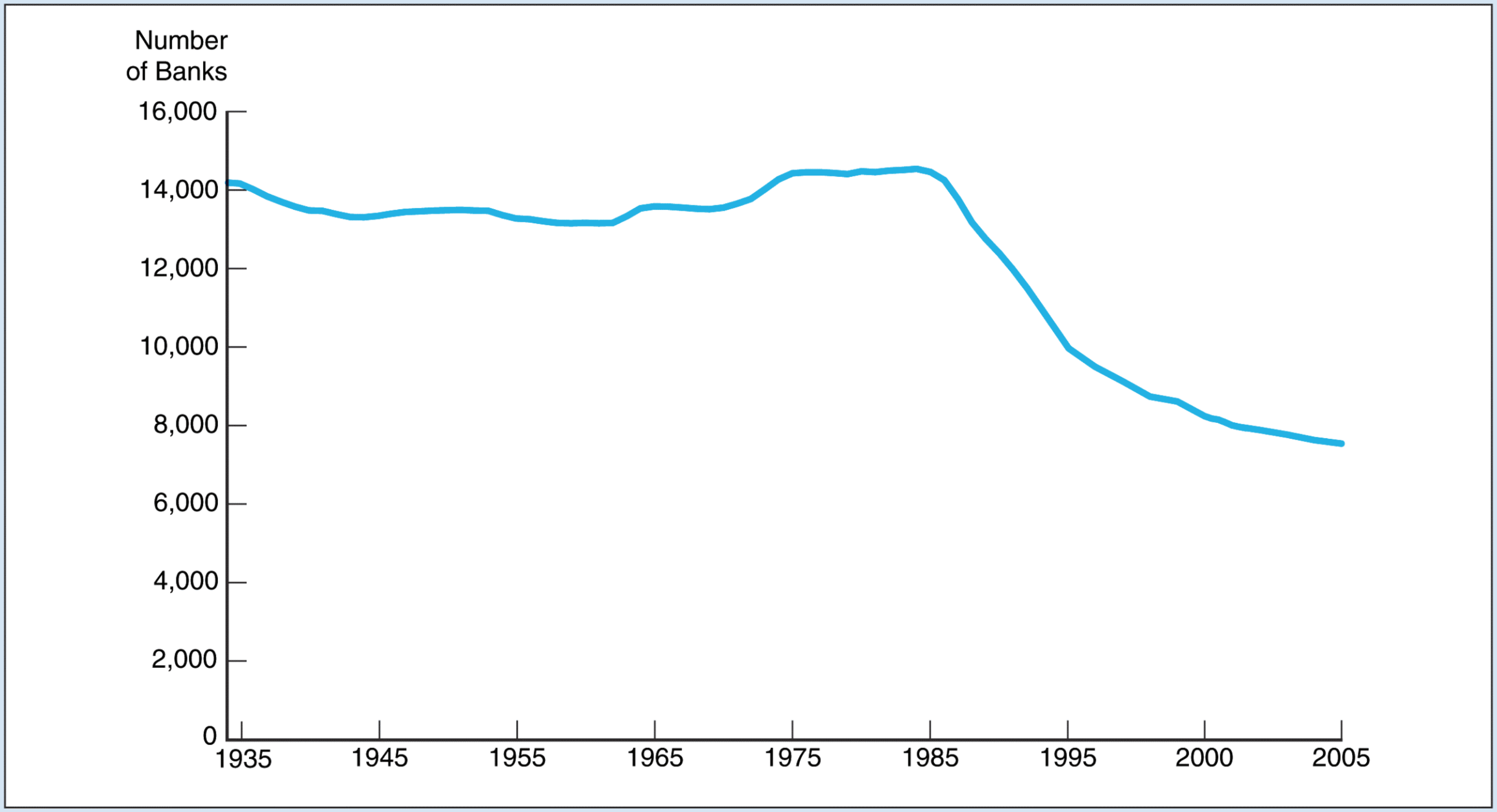

FIGURE 3 **Number of Insured Commercial Banks in the United States, 1934–2005**

Source: www2.fdic.gov/qbp/qbpSelect.asp?menuitem=STAT.

Separation of Banking and Other Financial Services

- Glass-Steagall Act of 1933
  - Prohibited commercial banks from underwriting corporate securities or engaging in brokerage activities
  - Section 20 loophole was allowed by the Federal Reserve enabling affiliates of approved commercial banks to underwrite securities as long as the revenue did not exceed a specified amount
  - U.S. Supreme Court validated the Fed's action in 1988

Separation of Banking and Other Financial Services (cont'd)

- Gramm-Leach-Bliley Financial Services Modernization Act of 1999
  - Abolishes Glass-Steagall
  - States regulate insurance activities
  - SEC keeps oversight of securities activities
  - Office of the Comptroller of the Currency regulates bank subsidiaries engaged in securities underwriting
  - Federal Reserve oversees bank holding companies

Three Basic World Frameworks

- Universal banking
  - No separation between banking and securities industries
- British-style universal banking
  - May engage in security underwriting
    - Separate legal subsidiaries are common
    - Bank equity holdings of commercial firms are less common
    - Few combinations of banking and insurance firms

Three Basic World Frameworks (cont'd)

- Some legal separation
  - Allowed to hold substantial equity stakes in commercial firms but holding companies are illegal

Thrift Industry: Regulation and Structure

- Savings and Loan Associations
  - Chartered by the federal government or by states
  - Most are members of Federal Home Loan Bank System (FHLBS)
  - Deposit insurance provided by Savings Association Insurance Fund (SAIF), part of FDIC
  - Regulated by the Office of Thrift Supervision
- Mutual Banks
  - Approximately half are chartered by states
  - Regulated by state in which they are located
  - Deposit insurance provided by FDIC or state insurance

Thrift Industry: Regulation and Structure (cont'd)

- Credit Unions
  - Tax-exempt
  - Chartered by federal government or by states
  - Regulated by the National Credit Union Administration (NCUA)
  - Deposit insurance provided by National Credit Union Share Insurance Fund (NCUSIF)

International Banking

- Rapid growth
  - Growth in international trade and multinational corporations
  - Global investment banking is very profitable
  - Ability to tap into the Eurodollar market

Eurodollar Market

- Dollar-denominated deposits held in banks outside of the U.S.
- Most widely used currency in international trade
- Offshore deposits not subject to regulations
- Important source of funds for U.S. banks

Structure of U.S. Banking Overseas

- Shell operation
- Edge Act corporation
- International banking facilities (IBFs)
  - Not subject to regulation and taxes
  - May not make loans to domestic residents

Foreign Banks in the U.S.

- Agency office of the foreign bank
  - Can lend and transfer fund in the U.S.
  - Cannot accept deposits from domestic residents
  - Not subject to regulations
- Subsidiary U.S. bank
  - Subject to U.S. regulations
  - Owned by a foreign bank

Foreign Banks in the U.S. (cont'd)

- Branch of a foreign bank
  - May open branches only in state designated as home state or in state that allow entry of out-of-state banks
  - Limited-service may be allowed in any other state
- Subject to the International Banking Act of 1978
- Basel Accord (1988)
  - Example of international coordination of bank regulation
  - Sets minimum capital requirements for banks

TABLE 3 Ten Largest Banks in the World, 2005

	Bank	Assets (U.S. $ millions)
1.	Citigroup, U.S.	1,484,100
2.	Mizuho Financial, Japan	1,306,600
3.	BNP Paribas, France	1,228,030
4.	J. P. Morgan Chase, U.S.	1,138,470
5.	Royal Bank of Scotland, Scotland	1,119,900
6.	Bank of America, U.S.	1,110,460
7.	HSBC Group, U.K.	1,031,290
8.	Mitsubishi Tokyo Financial, Japan	1,014,560
9.	Barclays, U.K.	1,002,090
10.	Credit Agricole, France	987,790

Source: www.forbes.com/2005/03/30/05f2000land.html.