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

- 1782: Bank of North America is chartered.
- 1791: Bank of the United States is chartered.
- 1811: Bank of the United States' charter is allowed to lapse.
- 1816: Second Bank of the United States is chartered.
- 1863: Andrew Jackson vetoes rechartering of Second Bank of the United States; charter lapses in 1836.
- 1933: Banking Act of 1933 (Glass-Steagall) creates Federal Deposit Insurance Corporation (FDIC) and separates banking and securities industries.
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

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>
<thead>
<tr>
<th>Assets</th>
<th>Number of Banks</th>
<th>Share of Banks (%)</th>
<th>Share of Assets Held (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $100 million</td>
<td>3,523</td>
<td>46.72</td>
<td>1.92</td>
</tr>
<tr>
<td>$100 million–$1 billion</td>
<td>3,552</td>
<td>47.10</td>
<td>11.45</td>
</tr>
<tr>
<td>$1 billion–$10 billion</td>
<td>380</td>
<td>5.04</td>
<td>12.76</td>
</tr>
<tr>
<td>More than $10 billion</td>
<td><strong>86</strong></td>
<td><strong>1.14</strong></td>
<td><strong>73.86</strong></td>
</tr>
<tr>
<td>Total</td>
<td><strong>7,541</strong></td>
<td><strong>100.00</strong></td>
<td><strong>100.00</strong></td>
</tr>
</tbody>
</table>

*Source: [www2.fdic.gov/SDF/SOB/](http://www2.fdic.gov/SDF/SOB/).*
<table>
<thead>
<tr>
<th>Bank</th>
<th>Assets ($ millions)</th>
<th>Share of All Commercial Bank Assets (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Bank of America Corp., Charlotte, NC</td>
<td>1,057,298</td>
<td>12.19</td>
</tr>
<tr>
<td>2. J. P. Morgan Chase, Columbus, OH</td>
<td>1,008,426</td>
<td>11.63</td>
</tr>
<tr>
<td>4. Wachovia Corp., Charlotte, NC</td>
<td>477,994</td>
<td>5.51</td>
</tr>
<tr>
<td>5. Wells Fargo, Sioux Falls, SD</td>
<td>380,109</td>
<td>4.38</td>
</tr>
<tr>
<td>6. U.S. Bancorp, Cincinnati, OH</td>
<td>206,667</td>
<td>2.38</td>
</tr>
<tr>
<td>7. SunTrust Bank, Atlanta, GA</td>
<td>170,774</td>
<td>1.97</td>
</tr>
<tr>
<td>8. HSBC Bank US, Wilmington, DE</td>
<td>145,949</td>
<td>1.68</td>
</tr>
<tr>
<td>9. State Street B &amp; T Corp., Boston, MA</td>
<td>91,404</td>
<td>1.05</td>
</tr>
<tr>
<td>10. Keybank, Cleveland, OH</td>
<td>87,574</td>
<td>1.01</td>
</tr>
<tr>
<td>Total</td>
<td>4,330,811</td>
<td>49.93</td>
</tr>
</tbody>
</table>

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

*Source: [www.forbes.com/2005/03/30/05f2000land.html](http://www.forbes.com/2005/03/30/05f2000land.html).*