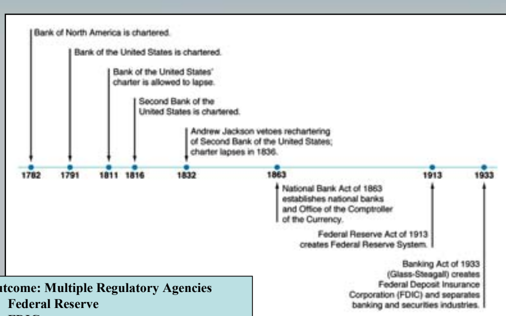
CHAPTER 10

Banking Industry: Structure and Competition

Historical Development of the Banking Industry



Outcome: Multiple Regulatory Agencies
1. **Federal Reserve**
2. **FDIC**
3. **Office of the Comptroller of the Currency**
4. **State Banking Authorities**

Financial Innovation

Innovation is result of search for profits

Response to Changes in Demand

Major change is huge increase in interest-rate risk starting in 1970s

Example: Adjustable-rate mortgages

Financial Derivatives (e.g., future contracts)

Response to Change in Supply

Major change is improvement in computer technology

1. Increases ability to collect information
2. Lowers transaction costs

Examples:

1. Bank credit and debit cards
2. Electronic banking facilities
3. Junk bonds
4. Commercial paper market
5. Securitization

Avoidance of Existing Regulations

Regulations Behind Financial Innovation

1. Reserve requirements

   Tax on deposits = $i \times r$ = lost interest on cash

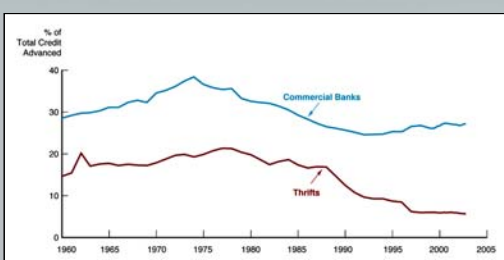
2. Deposit-rate ceilings (Reg Q)

   As $i \uparrow$, "loophole mine" [Edward Kane] to escape reserve requirement tax and deposit-rate ceilings

Examples

1. Money market mutual funds [1971] (checking account deposits that are not subject to reserve requirement or regulation Q)
2. Sweep accounts (above threshold are swept)

The Decline in Banks as a Source of Finance



Decline in Traditional Banking

Loss of Cost Advantages in Acquiring Funds (Liabilities)

$\pi \uparrow i \uparrow$ then disintermediation because

1. Deposit rate ceilings and regulation Q
2. Money market mutual funds
3. Foreign banks have cheaper source of funds: Japanese banks can tap large savings pool

Loss of Income Advantages on Uses of Funds (Assets)

1. Easier to use securities markets to raise funds: commercial paper, junk bonds, securitization
2. Finance companies more important because easier for them to raise funds

Banks' Response

Loss of cost advantages in raising funds and income advantages in making loans causes reduction in profitability in traditional banking

1. Expand lending into riskier areas: e.g., real estate
2. Expand into off-balance sheet activities
3. Creates problems for U.S. regulatory system

Similar problems for banking industry in other countries

Structure of the Commercial Banking Industry

Table 1 Size Distribution of Insured Commercial Banks, September 30, 2002

Assets	Number of Banks	Share of Banks (%)	Share of Assets Held (%)
Less than $25 million	796	10.0	0.2
$25–$50 million	1,421	17.9	0.8
$50–$100 million	2,068	26.1	2.2
$100–$500 million	2,868	36.2	8.6
$500 million–$1 billion	381	4.8	3.7
$1–$10 billion	319	4.0	13.2
More than $10 billion	80	1.0	71.3
Total	7,933	100.0	100.0

Source: www.fdic.gov/bank/statistical/statistics/0209/allstru.html.

Ten Largest U.S. Banks

Table 2 Ten Largest U.S. Banks, February 2003

Bank	Assets ($ millions)	Share of All Commercial Bank Assets (%)
1. Citibank, National Association, New York	1,057,657	15.19
2. JP Morgan Chase, New York	712,508	10.23
3. Bank of America, National Association, Charlotte, N.C.	619,921	8.90
4. Wachovia National Bank, Charlotte, N.C.	319,853	4.59
5. Wells Fargo, National Association, San Francisco	311,509	4.47
6. Bank One, National Association, Chicago	262,947	3.77
7. Taunus Corporation, New York	235,867	3.39
8. Fleet National Bank, Providence, R.I.	192,032	2.76
9. ABN Amro, North America, Chicago	174,451	2.50
10. US Bancorp, Minneapolis, Minnesota	164,745	2.36
Total	4,051,490	58.16

Source: www.infoplease.com/pia/A0763206.html.

Branching Regulations

Branching Restrictions: McFadden Act and Douglas Amendment

Very anticompetitive

Response to Branching Restrictions

1. Bank Holding Companies

A. Allowed purchases of banks outside state

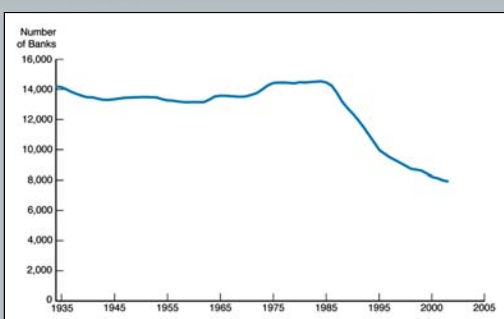
B. BHCs allowed wider scope of activities by Fed

C. BHCs dominant form of corporate structure for banks

2. Automated Teller Machines

Not considered to be branch of bank, so networks allowed

Bank Consolidation and Number of Banks



Bank Consolidation and Nationwide Banking

Bank Consolidation: Why?

1. Branching restrictions weakened

2. Development of super-regional banks

Riegle-Neal Act of 1994

1. Allows full interstate branching

2. Promotes further consolidation

Future of Industry Structure

Will become more like other countries, but not quite

Bank Consolidation and Nationwide Banking

Bank Consolidation: A Good Thing?

Cons:

1. Fear of decline of small banks and small business lending
2. Rush to consolidation may increase risk taking

Pros:

1. Community banks will survive
2. Increase competition
3. Increased diversification of bank loan portfolios: lessens likelihood of failures

Separation of Banking and Other Financial Service Industries

Erosion of Glass-Steagall

Fed, OCC, FDIC, allow banks to engage in underwriting activities

Gramm-Leach-Bliley Financial Modernisation Services Act of 1999: Repeal of Glass-Steagall

1. Allows securities firms and insurance companies to purchase banks
2. Banks allowed to underwrite insurance and engage in real estate activities
3. OCC regulates bank subsidiaries engaged in securities underwriting
4. Fed oversee bank holding companies under which all real estate, insurance and large securities operations are housed

Implications: Banking institutions become larger and more complex

Separation in Other Countries

1. Universal banking: Germany
2. British-style universal banking (separate legal subsidiaries)
3. U.S./Japan separation

Savings and Loans

Regulators

1. Office of Thrift Supervision (OTS)
2. Federal Home Loan Bank System (FHLBS)
3. FDIC’s Saving Association Insurance Fund (SAIF)
4. State banking authorities

Structure

Fewer restrictions on branching

Mutual Savings Banks

Regulators

1. FDIC
2. States

Structure

1. 400 or so
2. Within-state branching regulations not restrictive, so there are few small MSBs

Credit Unions

Regulators

1. National Credit Union Administration (NCUA)
2. States

Structure

- Because must have common bond of depositors, most are small with deposits < $10 million

International Banking

The Reasons for Rapid Growth

1. Rapid growth of international trade
2. Banks abroad can pursue activities not allowed in home country
3. Tap into Eurodollar market

U.S. Banks Overseas

1. Regulators
   A. Federal Reserve (Regulation K)
2. Structure
   A. Edge Act Corporations (foreign holding of companies and lending)
   B. International Banking Facilities (IBF in 1981 approved by the Fed)

Foreign Banks in U.S.

1. Regulators
   A. Same as for U.S. domestic banks
2. Structure
   A. 500 offices in U.S.
   B. 20% of total U.S. bank assets

Ten Largest Banks in the World

Table 3 Ten Largest Banks in the World, 2002

Bank	Assets (U.S. $ millions)
1. Mizuho Holdings, Japan	1,281,389
2. Citigroup, U.S.	1,057,657
3. Mitsubishi Tokyo Financial Group, Japan	854,749
4. Deutsche Bank, Germany	815,126
5. Allianz, Germany	805,433
6. UBS, Switzerland	753,833
7. BNP, France	734,833
8. HSBC Holdings, U.K.	694,590
9. J.P. Morgan & Chase Company, U.S.	712,508
10. Bayerische Hypo-Und Vereinsbanken, Germany	638,544

Source: American Banker, 167 (132): 17, July 12, 2002.