

Chapter 11

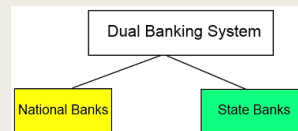
Banking Industry: Structure and Competition

Contents

- Assess the reasons for **separating banking** from other **financial services** through **legislation**.
- Summarize the distinctions between **thrift institutions** and commercial banks.
- **Identify** the reasons for U.S. banks to operate in **foreign countries** and for **foreign** banks to **operate** in the **United States**.

Historical Development of the Banking System

- Bank of **North** America **chartered** in 1782
- National Bank Act of **1863** creates a new banking system of federally chartered banks
 - Office of the **Comptroller** of the Currency
 - **Dual** banking system
- Federal Reserve System is created in 1913.



Primary Supervisory Responsibility of Bank Regulatory Agencies

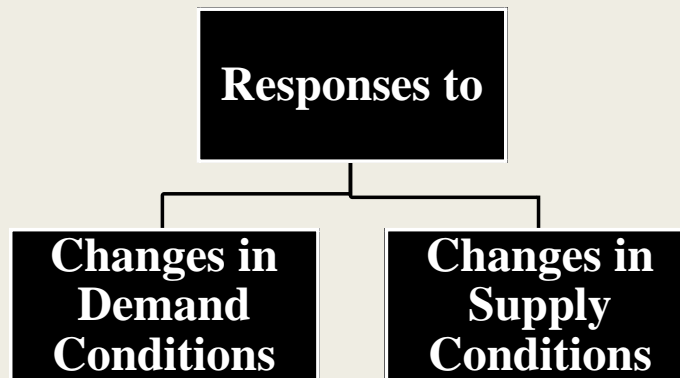
- **Federal Reserve** and **state banking authorities**: state banks that are members of the Federal Reserve System.
- **Fed** also **regulates** bank **holding companies**.
- **FDIC (Federal Deposit Insurance Corporation)**: **insured** state banks that are **not** Fed members.
- State banking authorities: **insure** state banks without FDIC insurance.

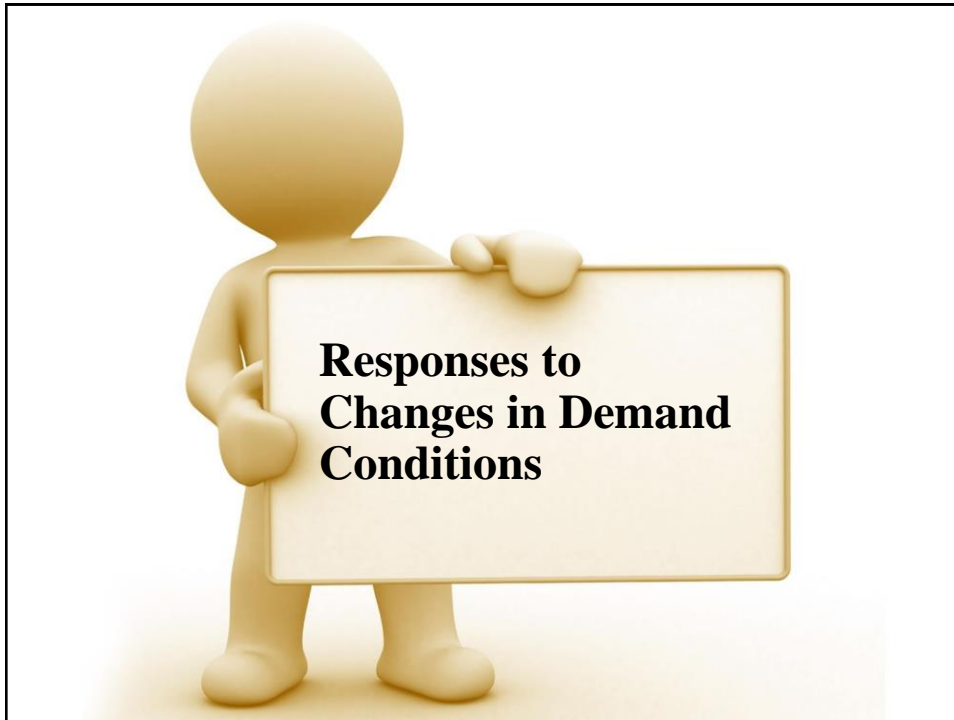
Financial Innovation and the Growth of the “Shadow Banking System”

- **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
 - **Financial engineering**



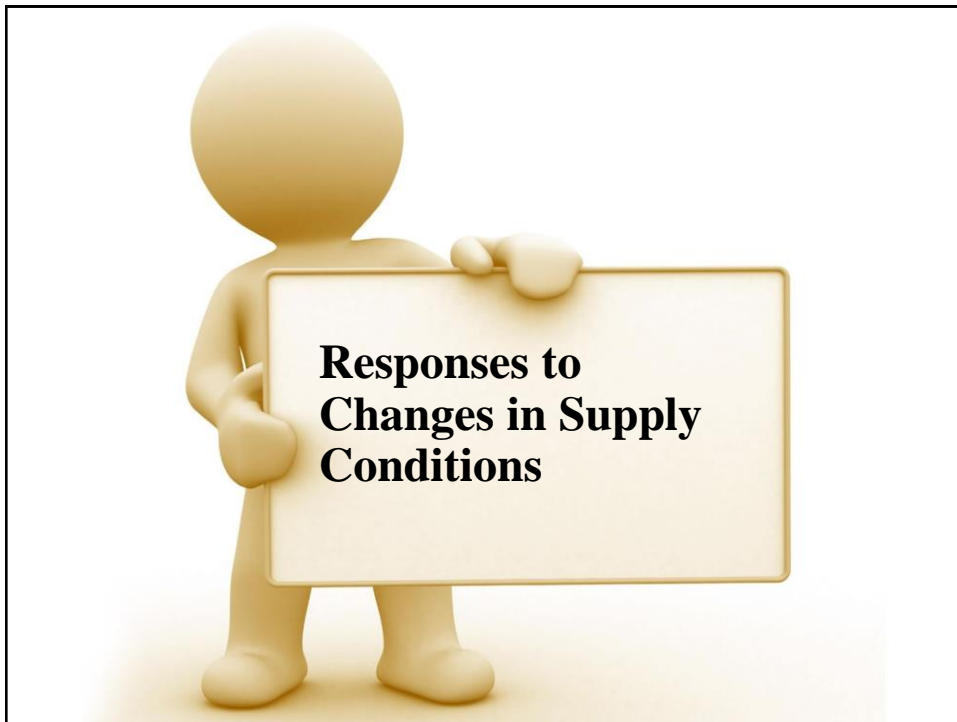
Financial Innovation is required to confront various financial fluctuations:





Responses to Changes in Demand Conditions: Interest-Rate Volatility

- **Adjustable-rate mortgages (ARM)**
 - **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 (i.e. derived from) securities.



Responses to Changes in Supply Conditions: Information Technology

- **Bank credit and debit cards**
 - Improved computer technology lowers transaction costs
- **Electronic banking**
 - ATM, ABM, home banking, and virtual banking
- **Junk bonds:** a high-yielding high-risk security, typically issued by a company seeking to raise capital quickly in order to finance a takeover.
- **Commercial paper market**

Securitization and the Shadow Banking System

Securitization

- To transform **illiquid financial** assets (real estate & stocks with low trading volume) into **marketable capital market securities**.
- Securitization played an especially prominent role in the development of **the subprime mortgage market** in the mid 2000s.



**Avoidance of
Existing Regulations**

Avoidance of Existing Regulations

■ Loophole Mining:

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

Reserve requirements are the amount of cash that banks must have, in their vaults or at the Federal Reserve bank, in line with deposits made by their customers.

Disintermediation: reduction in the use of intermediaries between lenders and borrowers, **for example** by investing directly in the securities market rather than through a bank.

A **money market fund** (also called a **money market mutual fund**) is an open-ended mutual **fund** that invests in short-term debt securities such as US Treasury bills and commercial paper. **Money market funds** are widely regarded as being as safe as bank deposits yet providing a **higher yield**.

A **sweep account** is a bank **account** that automatically transfers amounts that exceed, or fall short of, a certain level into a **higher interest-earning** investment option at the close of each business day.

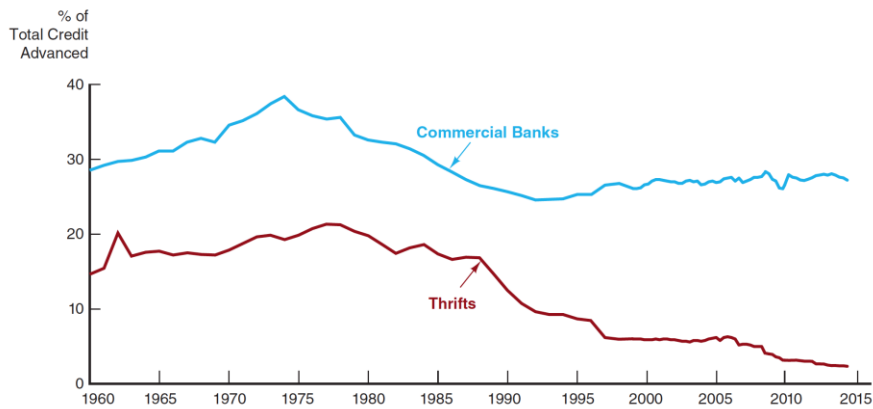
Commonly, the excess cash is swept into **money market funds**.



Financial Innovation and the Decline of Traditional Banking

- As a source of **funds** for borrowers, market share has fallen.
- Commercial banks' 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, 1960–2014

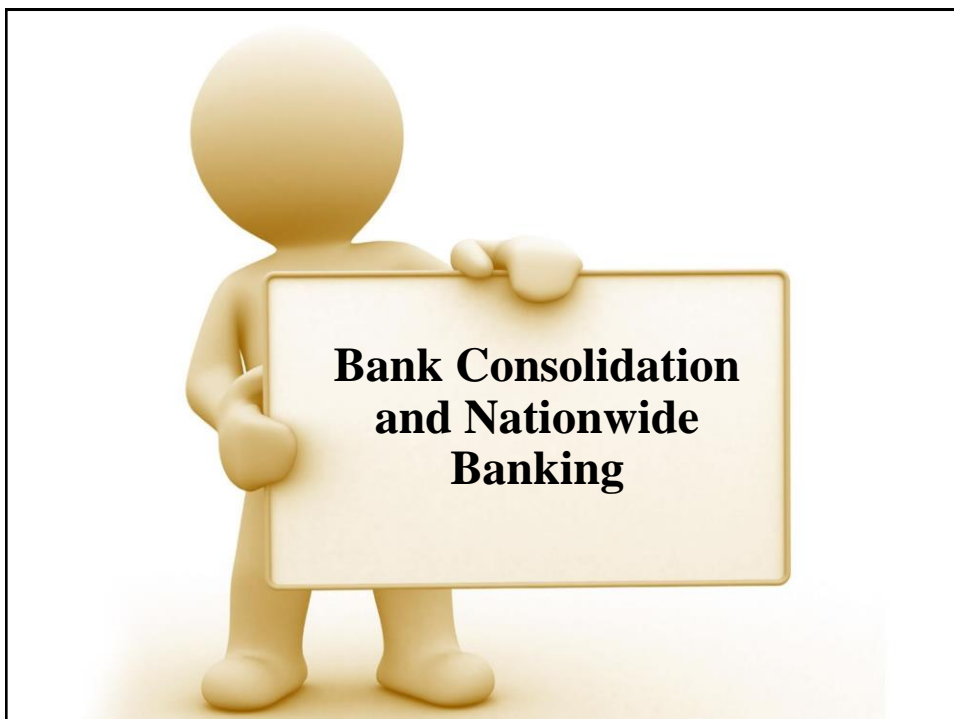


Source: Federal Reserve Bank of St. Louis, FRED data base:
<http://research.stlouisfed.org/fred2/>; <https://www2.fdic.gov/hsob/index.asp>.

- **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
 - Corporate takeovers and leveraged buyouts
- **Pursue off-balance-sheet activities**
 - **Non-interest income**
 - **Concerns about risk**



What Is Bank Consolidation?

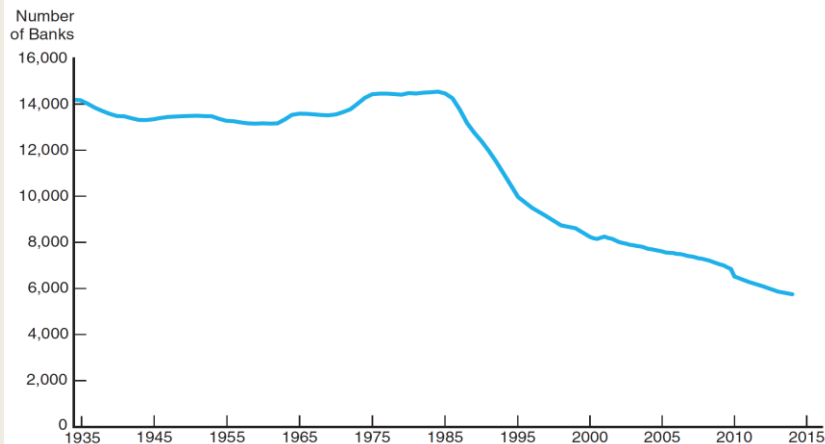
- Beginning in the early 2000s, the United States began to experience a great increase in the number of large bank mergers, including Bank of America with FleetBoston and JPMorgan Chase with Bank One.

Bank Consolidation

- Bank consolidation is the **process** by which one **banking company** takes over or merges with another.
- This **convergence** leads to a **potential** expansion for the **consolidating** banking institution.

- The **number** of **banks** has **declined** dramatically over the last 30 years.
 - **Bank failures** and **consolidation**
 - **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**.

Figure 3 Number of Insured Commercial Banks in the United States, 1934–2014 (Third Quarter)



Source: Federal Reserve Bank of St. Louis, FRED database: <http://research.stlouisfed.org/fred2/>.

What will the Structure of the U.S. Banking Industry Look Like in the Future?

- **Although** the U.S. retains a **unique banking structure** in possessing a large number of banks, its structure is **converging** with systems in Europe and Japan.
- **How far the convergence** between banking systems will extend is the subject of ongoing academic debate

Are Bank Consolidation and Nationwide Banking Good Things?

■ Benefits

- **Increased** competition, **driving inefficient** banks out of **business**
- Also, **increased** efficiency 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**



■ 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 (*Federal Deposit Insurance Corporation*)
- Regulated by the **Office of Thrift Supervision**

■ **Mutual savings banks**

- Approximately half are chartered by **states.**
- **Regulated** by **state** in which they are **located.**
- **Deposit insurance** provided by FDIC or **state insurance**

■ **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)**



■ **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 strict regulations.

