

## Chapter 10: Banking Industry: Structure and Competition

# 1 Historical Development of the Banking System

Dual banking system:

- *State Banks* are chartered and supervised by the states.
- *National banks* are chartered and supervised by the federal government.

## **2 Financial Innovation and the Evolution of the Banking Industry**

**A change in the financial environment will stimulate a search by financial institutions for innovations that are likely to be profitable.**

### **2.1 Responses to Changes in Demand Conditions: Interest Volatility**

An important change in the financial environment since the 1950s: The increase in the volatility of interest rates.

Three-month Treasury bills interest rate fluctuated between

- The 1950s: 1.0% and 3.5%
- The 1970s: 4.0% and 11.5%
- The 1980s: 5% and more than 15%

### **2.1.1 Adjustable-Rate Mortgages**

In 1975, savings and loans in California began to issue adjustable-rate mortgages.

Initial interest rates on adjustable-rate mortgages are lower than those on conventional fixed-rate mortgages.

### **2.1.2 Financial Derivatives**

Banks use financial derivatives such as futures contracts to deal with interest rate risk (Chapter 13).

## **2.2 Responses to Changes in Supply Conditions: Information Technology**

Improvement in *information technology* (computer and telecommunication technology)

### **2.2.1 Bank Credit and Debit Cards**

Improved information technology made credit and debit cards successful.

## 2.2.2 Electronic Banking

*automated teller machine (ATM)*

*automated banking machine (ABM)*: ABM combines in one location an ATM, an internet connection to the bank's web site, and a telephone link to customer service.

## 2.2.3 Securitization

*Securitization*: The process of transforming otherwise illiquid financial assets (such as residential mortgages, auto loans, and credit card receivables) into marketable capital market securities.

An example: A financial institution bundles mortgage loans together and the claims to interest and principal payments for these loans are sold as a security to a third party.

### **3 Avoidance of Existing Regulations**

Two sets of regulations:

1. *Reserve requirements* The Fed does not pay interest on reserves. A bank pays taxes on deposits of lost interest as an opportunity cost.

2. *Restrictions on interest paid by reserve requirements* Until 1980, legislation prohibited banks in most states from paying interest on checking account deposits, and through Regulation Q, the Fed set maximum limits on the interest rate on time deposits.

### **3.1 Money Market Mutual Funds**

Money market mutual funds issue shares that are redeemable by writing checks. They function as checkable deposits, but not legally checkable deposits. This is an innovation that avoided both sets of regulations above.

## **3.2 Sweep Accounts**

In *sweep accounts*, any balances above a certain amount in a corporation's checking account at the end of a business day are "swept out" of the account and invested in overnight securities that pay interest. This is another innovation that avoided both sets of regulations.

## **4 Financial Innovation and the Decline of Traditional Banking**

The traditional role of banking: Make long-term loans and issue short-term deposits.

See Figure 2.

## **4.1 Decline in Cost Advantages in Acquiring Funds (Liabilities)**

When market interest rates on bonds were low in 1960s, Regulation Q worked to the banks' advantage to limit competition among banks.

When interest rates started to rise, Regulation Q worked against banks as they competed with other financial institutions.

## **4.2 Decline in Income Advantages on Uses of Funds (Assets)**

- The emergence of junk bonds
- Securitization

## **5 Structure of the U.S. Commercial Banking Industry**

There are approximately 7,500 commercial banks in the United States, far more than in any other country in the world.

Table 1: There are many small banks.

Table 2: The ten largest commercial banks in the United States hold just 50% of the assets of the banks.

## 5.1 Restrictions on Branching

Past regulations on opening *branches* (additional offices for the conduct of banking operations

The McFadden Act of 1972 effectively prohibited banks from branching across state lines.

Branching regulations did not encourage competition, and prevented banks to take advantage of economies of scale.

## **5.2 Response to Branching Regulations**

### **5.2.1 Bank Holding Companies**

A bank holding company is a corporation that owns several different banks.

### **5.2.2 Automated Teller Machines**

## **6 Bank Consolidation and Nationwide Banking**

In 1975, Maine enacted the first interstate banking legislation.

By the early 1990s, almost all states allowed some form of interstate banking.

Merges, acquisitions, and bank holding companies explain the banking consolidation.

## **7 Separation of the Banking and Other Financial Service Institutions**

The Glass-Steagall Act of 1933 separated the banking and other financial services industries.

## **7.1 Erosion of Glass-Steagall**

Brokerage firms engaged in the banking business with the development of money market mutual funds and cash management accounts.

The regulatory agencies used a loophole in the Glass-Steagall Act to allow bank holding companies and banks to engage in financial services such as underwriting corporate securities.

## **7.2 The Gramm-Leach-Bliley Financial Services Modernization Act of 1999: Repeal of Glass-Steagall**

The Gramm-Leach-Bliley Financial Services Modernization Act of 1999 eliminated the Glass-Steagall Act.

It allows securities firms and insurance companies to purchase banks.

it allows banks to underwrite insurance and securities and engage in real estate activities.