Evolution of the Banking Industry in US

Before 1863
__No national currency existed.
__All commercial banks are chartered by the state government. Banknotes are redeemable for species.
__1791-1836, both Bank of the United States and the Second Bank of the United States have elements of a private bank and a central bank.
__1836-1863, Free banking era. Banking regulations were extremely lax in many states. New reports suggested fraud, bank failure, wildcat banking were widespread.

1863 National Bank Act
__Create a new system of federally chartered banks (national banks), supervised by the Comptroller of the Currency.
__Impose taxes on banknotes issued by state chartered banks (state banks).
__State banks devised checkable demand deposits for the source of funds and survived.
__A dual banking system (state banks chartered by state governments and national banks chartered by federal government)

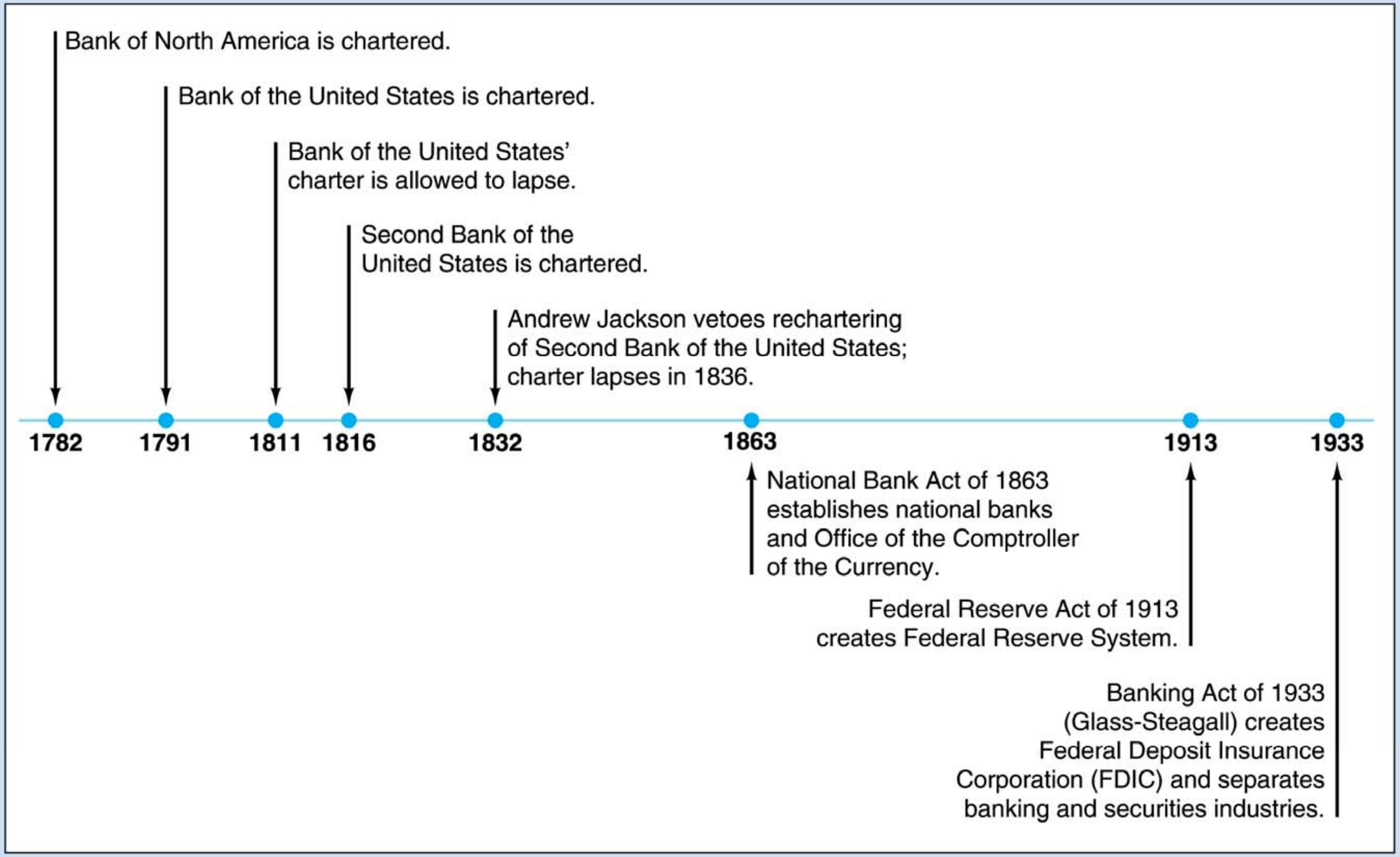

FIGURE 1 **Time Line of the Early History of Commercial Banking in the United States**

1863-1913
__5 major bank panics

1913 Federal Reserve Act
__create Federal Reserve System (FRS)
__National banks are required to become members of FRS
__State banks can choose to be members of FRS

1927 McFadden Act
__Forbid interstate branch banking (repealed by Riegle-Neal Act 1994 (effective 1997))
__Many small banks survived. Lack of competition.

1929-1933
__the Great Depression
__Around 9000 banks failed.

1933 Banking Act (Glass-Steagall Act, repealed by GLB Act 1999)
__Separate commercial banking and underwriting
__Create Federal Deposit Insurance Corporation (FDIC)

Multiple 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

Financial Innovations as Responses to Changes in the Financial Environment

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

Responses to Demand for New Financial Products: Interest Rate Volatility
(1%-3.5% in 1970 to 4%-11.5% in 1980s)

1. Adjustable-rate mortgages
    - Flexible interest rates raise bank profits when rates rise
    - Lower initial interest rates make them attractive to home buyers
2. Financial Derivatives
    - To hedge interest rate risk, devise a new type of contracts (standardized contracts) that buy or sell on a specific future date at a pre-set price on existing securities
    - Chicago Board of Trade 1975

Responses to Changes in Supply Conditions: Information Technology (lower costs to devise new financial products and investors are easier to acquire information)

1. Bank credit and debit cards
    - Improved computer technology lowers the transaction costs
2. Electronic banking
    - ATM
    - Home banking
    - Automated Banking Machine (an ATM, internet connection and a telephone)
    - Virtual banking
3. Junk bonds – If it is easier to screen good from bad firms and to assess risk precisely, investors are more willing to purchase bonds issued by less well-known corporations that have a low credit ratings.
4. Commercial paper market
5. Securitization

Avoidance of Regulations: Loophole Mining

1. Reserve requirements act as a tax on deposits
    - Sweep accounts
2. Restrictions on interest paid on deposits (Regulation Q) led to disintermediation
    - Money market mutual funds
    - Repos

Decline of Traditional Banking

- As a source of funds for borrowers, market share has fallen
- Share of total financial intermediary assets has fallen, but there was no decline in overall profitability
- Decline in cost advantages in acquiring funds (liabilities)
  - Rising inflation led to rise in interest rates and disintermediation
  - Low-cost source of funds are available for banks, checkable deposits declined in importance
- Decline in income advantages on uses of funds (assets)
  - Alternative sources of finances are available for firms
  - 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

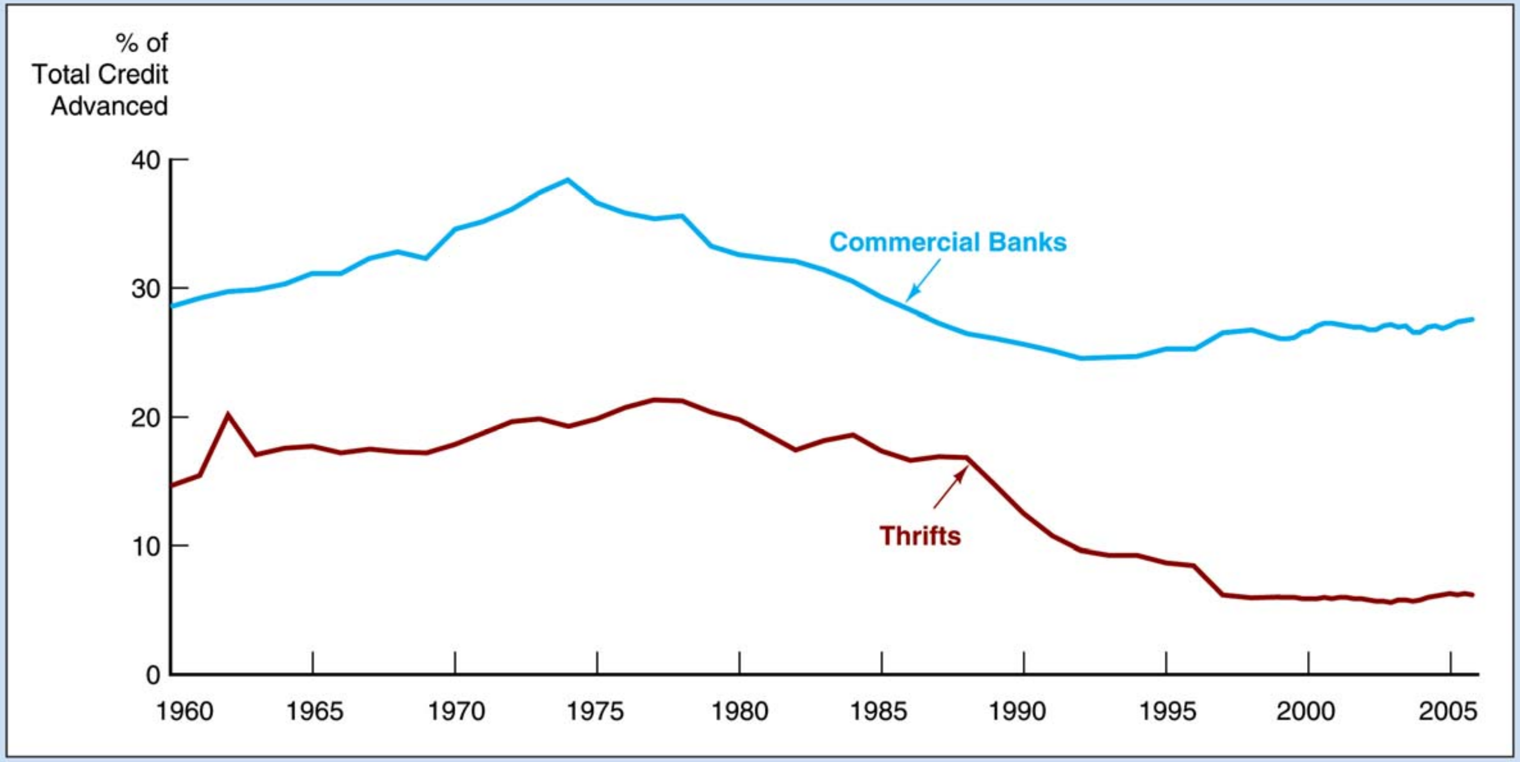

FIGURE 2 **Bank Share of Total Nonfinancial Borrowing, 1960–2005**

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

Branching

- McFadden Act 1927 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 (ATMs) are responses to these regulations
- Bank Holding Co. Act 1956 defined a bank to be taking deposits and make loans (This leads to creation of non-bank banks which take deposits or make loans only. The loophole was closed by the Competitive Equality Banking Act of 1987)

Bank Consolidation – see handouts for details

Benefits and Costs of Bank Consolidation

1. 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
2. Costs
   - Elimination of community banks may lead to less lending to small business
   - Banks expanding into new areas may take increased risks and fail
   - Too-big-to-fail

Separation of Banking and Other Financial Services

1. Glass-Steagall Act of 1933
   - Prohibited commercial banks from underwriting corporate securities or engaging in brokerage activities (firewall)
   - In 1987 Fed used a loophole in Section 20 of the Act to allow affiliates of approved commercial banks to underwrite securities as long as the revenue did not exceed a specified amount. The firewall started to crumble.

2. Gramm-Leach-Bliley (GLB) 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

Other Types of Banking Firm Organizations

1. Universal banking
    - Commercial banks provide banking, securities, real estate, and insurance services
    - Germany, Netherlands, Switzerland
2. British-style universal banking
    - May engage in security underwriting
    - UK, Canada, Australia
        - Separate legal subsidiaries are common
        - Bank equity holdings of firms are less common
        - Few combinations of banking and insurance firms

3. Legal separation of banking and other financial service industries
    - Japan
    - Allowed to hold substantial equity stakes in firms