Notes on Mishkin Chapters 11/12: Part A
U.S. Banking Structure & History

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Key Issues Addressed

- Key Empirical Facts About Current U.S. Commercial Banking Industry
- Historical Development of U.S. Commercial Banking

U.S. Banking: Key Empirical Facts

(Market) Concentration = Extent to which a relatively ***large*** share of market activity is carried out by a relatively ***small*** number of firms.

- **EMPIRICAL FACT 1:**

U.S. commercial banking industry is NOT very concentrated relative to many of its major trading partners.

Size Distribution of U.S. Insured Commercial Banks, September 30, 2008

Assets	Number of Banks	Share of Banks (%)	Share of Assets Held (%)
Less than $100 million	2,882	40.3	1.9
$100 million–$1 billion	3,755	52.6	11.4
$1 billion–$10 billion	425	6.0	12.8
More than $10 billion	84	1.2	73.9
Total	7,146	100.00	100.00

Source: www2.fdic.gov/qbp/2008sep/cb4.html.

Note: Mishkin 12, Table 1, p. 290

Ten Largest Banks in World (2008)

Bank	Assets (U.S. $ millions)
1. The Royal Bank of Scotland Group plc, UK	3,782,880.00
2. Deutsche Bank AG, Germany	2,953,727.00
3. BNP Paribas SA, France	2,477,272.00
4. Barclays PLC, UK	2,442,996.00
5. Credit Agricole SA, France	2,067,577.00
6. UBS AG, Switzerland	2,007,224.00
7. Societe Generale, France	1,566,904.00
8 ABN AMRO Holding NV, Netherlands	1,498,849.00
9. ING Bank NV, Netherlands	1,453,382.00
10. The Bank of Tokyo-Mitsubishi UFJ Ltd, Japan	1,362,598.00

Source: http://topforeignstocks.com/2008/07/25/the-top-10-banks-in-the-world-2008/.

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Note: Mishkin 12, Table 3, p. 303

U.S. Banking: Key Empirical Facts

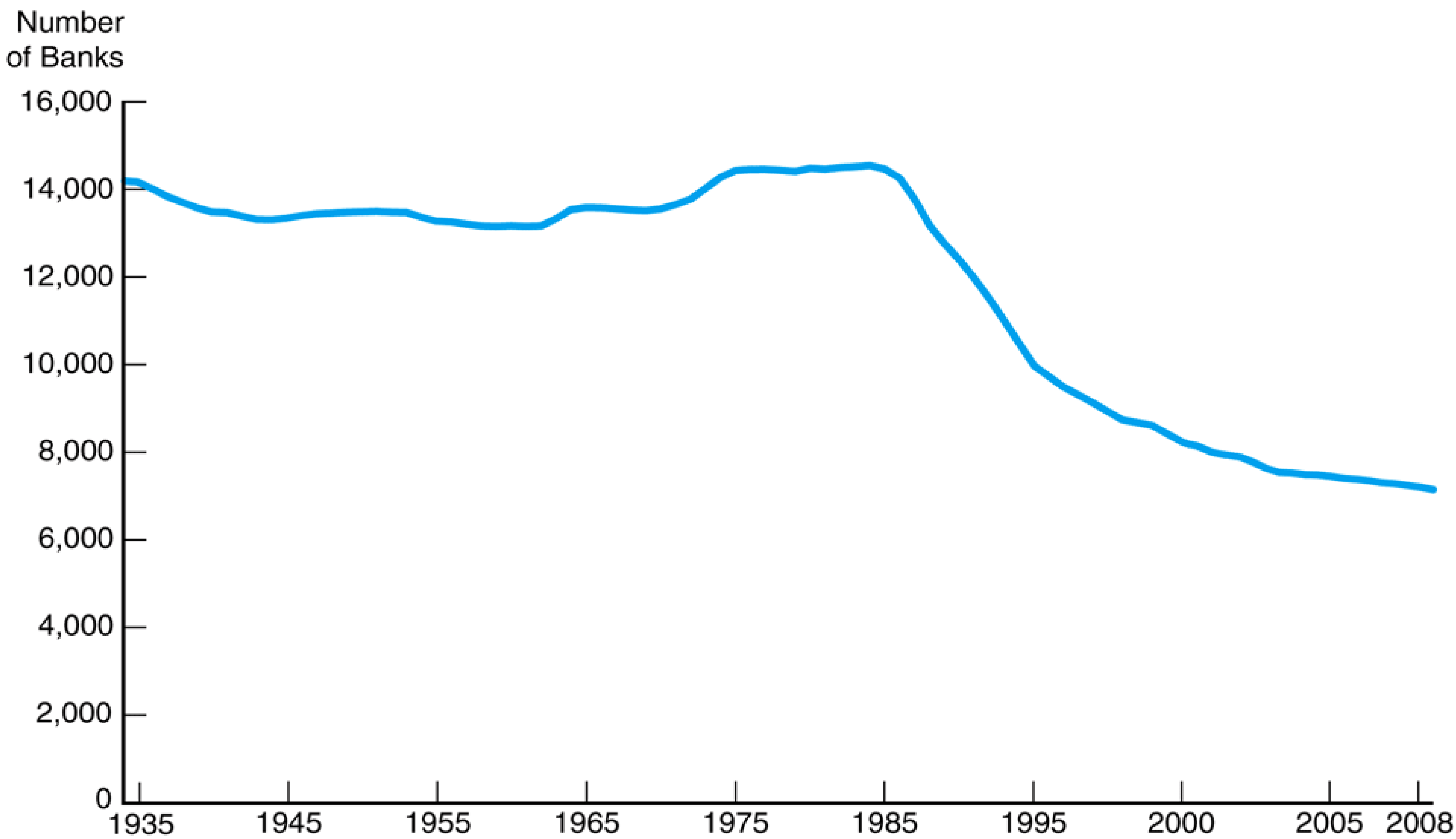
- **EMPIRICAL FACT 2:**

  Nevertheless, since 1985 the number of banks in the U.S. has been FALLING

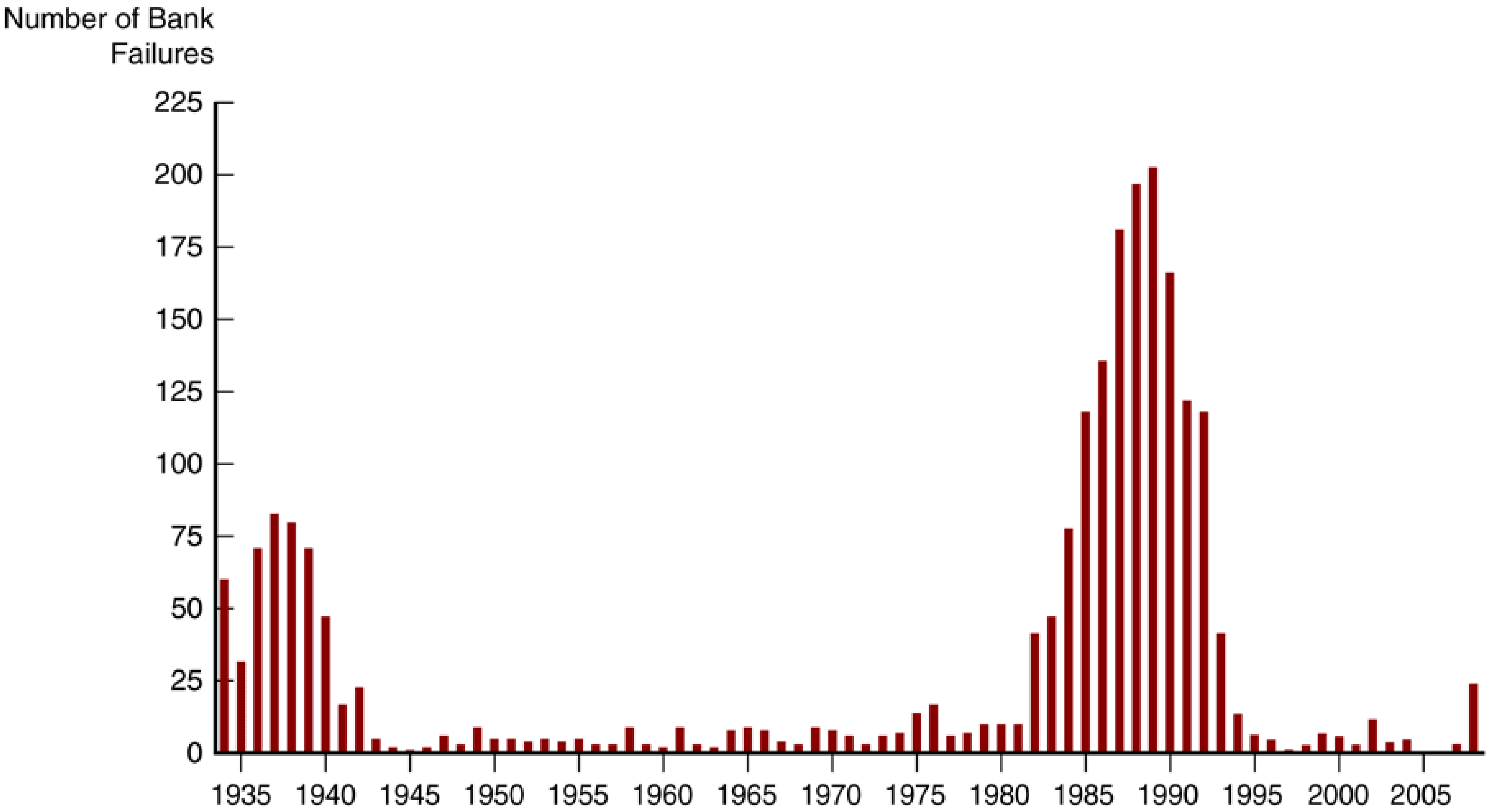
  Over 1985-2007, this was due **partly** to bank failures, but **mainly** to bank consolidations.

  During the 2007-2011 financial crisis, the decline in banks has largely been due to bank failures.

Number of Insured Commercial Banks in U.S. 1934-2008 (Mishkin 12, Fig 3, p. 292)



Bank Failures in the U.S. 1934-2008
(Mishkin 11, Fig 1, p. 266)



U.S. Banking: Key Empirical Facts

- **EMPIRICAL FACT 3:**

  Multiple overlapping regulatory agencies

Principal Regulatory Agencies of the U.S. Financial System (Mishkin 2, Table 5, p. 47)

Securities and Exchange Commission (SEC)	Organized exchanges and financial markets	Requires disclosure of information, restricts insider trading
Commodities Futures Trading Commission (CFTC)	Futures market exchanges	Regulates procedures for trading in futures markets
Office of the Comptroller of the Currency	Federally chartered commercial banks	Charters and examines the books of federally chartered commercial banks and imposes restrictions on assets they can hold
National Credit Union Administration (NCUA)	Federally chartered credit unions	Charters and examines the books of federally chartered credit unions and imposes restrictions on assets they can hold
State banking and insurance commissions	State-chartered depository institutions	Charter and examine the books of state-chartered banks and insurance companies, impose restrictions on assets they can hold, and impose restrictions on branching
Federal Deposit Insurance Corporation (FDIC)	Commercial banks, mutual savings banks, savings and loan associations	Provides insurance of up to $100,000 (temporarily $250,000) for each depositor at a bank, examines the books of insured banks, and imposes restrictions on assets they can hold
Federal Reserve System	All depository institutions	Examines the books of commercial banks that are members of the system, sets reserve requirements for all banks
Office of Thrift Supervision	Savings and loan associations	Examines the books of savings and loan associations, imposes restrictions on assets they can hold

U.S. Banking: Key Empirical Facts

- **EMPIRICAL FACTS 4, 5, and 6:**
  - Until 1994, strong ***branching*** restrictions.
  - Until 1999, ***separation*** of banking and securities activities.
  - ***Independent*** central bank (Federal Reserve System) with a ***complicated*** check and balance structure.

U.S. Banking: Early History

- **1782: Start of Modern Banking in the U.S.**
  - Bank of North America (Phil.) chartered
  - Success encourages opening of many additional banks
- **1782-1913: Struggle for Control**
  - ***See-saw battle*** between advocates of centralized control (Federalists) and advocates of state control (agric. and other interests)
  - Dispute not settled until Federal Reserve System established in 1913.

Breakdown of See-Saw Period

- **1791-1932: Federalists vs. States Rights**
  - Bank charters were repeatedly issued and then vetoed or allowed to lapse.
- **1832-1863: “Free Banking Period”**
  - States were given right to control banks within their own borders.
  - Banking was in fact conducted with little Federal government intervention.

1863: National Banking Act
(Resulted in Dual Banking System)

National Banks

- Chartered by Fed Gov't
- Supervised by Comptroller of the Currency in U.S. Treasury
- Allowed to issue bank notes (paper money backed by gold)

State Banks

- Charted by state governments
- Supervised by State Banking and Insurance Commissions
- Prohibitive tax imposed on bank note issue (so they created demand deposits and the concept of a check!)

1863-1913: Unsettled Times

- **Waves of bank failures occurred periodically**
- **No safety net for depositors**
- **Borrowers had difficulty raising funds**
- **Major bank panic in 1907**
  - Public finally convinced of the need for a central bank!

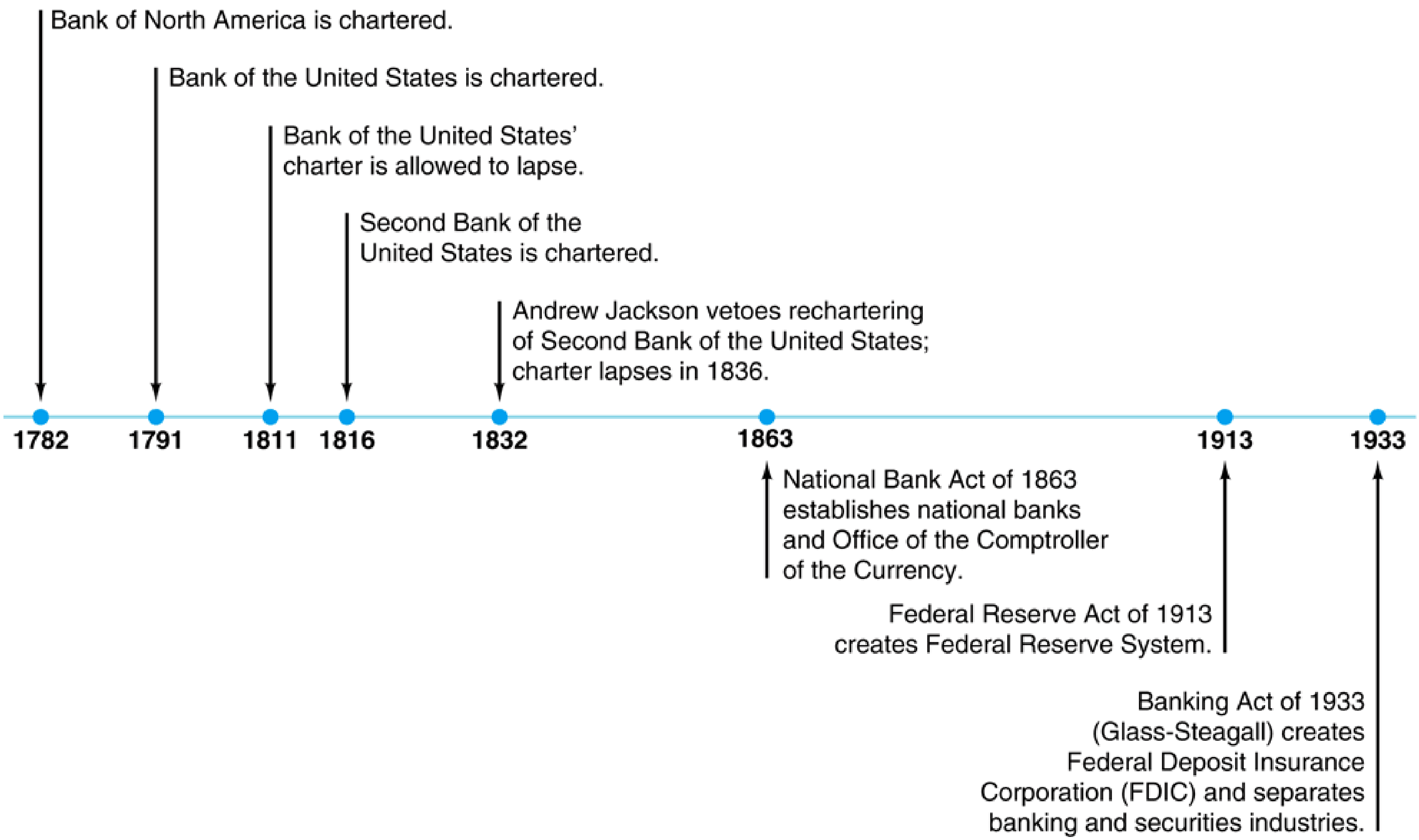
1913: Federal Reserve Act

- Establishment of a central banking ***system*** (the Federal Reserve System)
- Compromise solution with elaborate checks and balances
- Conservative goals – to promote a safe banking system
- Only one basic policy tool envisioned – provision of “discount loans” to member banks in emergency times when reserves needed
- Monopoly power over issuance of currency

Anti-Branching and Separation Acts

- **1927: McFadden Act**
  - Banks prohibited from branching across state lines
- **1933: Glass-Steagall Act**
  - FDIC insurance established
  - Separated commercial banking from the securities industry
  - Prohibited interest on checkable deposits
  - Put interest-rate ceilings on time deposits ("***Regulation Q***")

Summary of Early Banking History
(Mishkin 12, Fig 1, p. 276)



1945: Bretton Woods Agreement

- **GOAL** = Develop a new ***international*** monetary system
  - Created the ***International Monetary Fund (IMF)*** to maintain fixed exchange rates and makes loans to member countries with Balance-of-Payments problems
  - Created the ***World Bank*** to provide long-term loans to emerging market countries for economic development, financed by sale of bonds to developed countries.

1980-1982: Deregulation

- **1980: Depository Institutions…Act**
  - NOW accounts approved nation-wide;
  - Phased out interest rate ceilings;
  - Increased government-backed deposit insurance to $100,000 per account;
  - Gave wider activities latitude to thrifts.
- **1982: Garn-St. Germain**
  - Approved money market deposit accounts;
  - Gave even more latitude to thrifts to engage in new riskier activities (real estate loans, junk bond purchases,…).

1982-1989: U.S. Bank Crisis
(General Economic Context)

- Worry about inflation in late 1970s led Fed (Chaired by Volker) to sharply tighten the money supply starting in late 1979.
- Resulted in high interest rates and sharp deep recession in 1981-1982.
- Rapidly rising costs of funds for Savings and Loans (S&Ls) not matched by higher earnings on principal assets (residential mortgages) whose rates were fixed in the past.
- By some estimates, over half of S&Ls in U.S. were insolvent by end of 1982.

1982-1989: U.S. Bank Crisis
(Situation of Banks: Early Stages)

- Banks in early 1980s faced increased competition for sources of funds (same as thrifts)
- Forced to compete by ***offering*** higher interest rates on deposits (now allowed)
- Not matched by ***earnings*** on loans made at earlier times with lower interest rates – squeeze!
- Banks forced to seek out new riskier sources of profit (real estate loans, junk bonds, stocks…)
- Moral hazard between regulators/depositors and banks

1982-1989: U.S. Bank Crisis
(Later Stages)

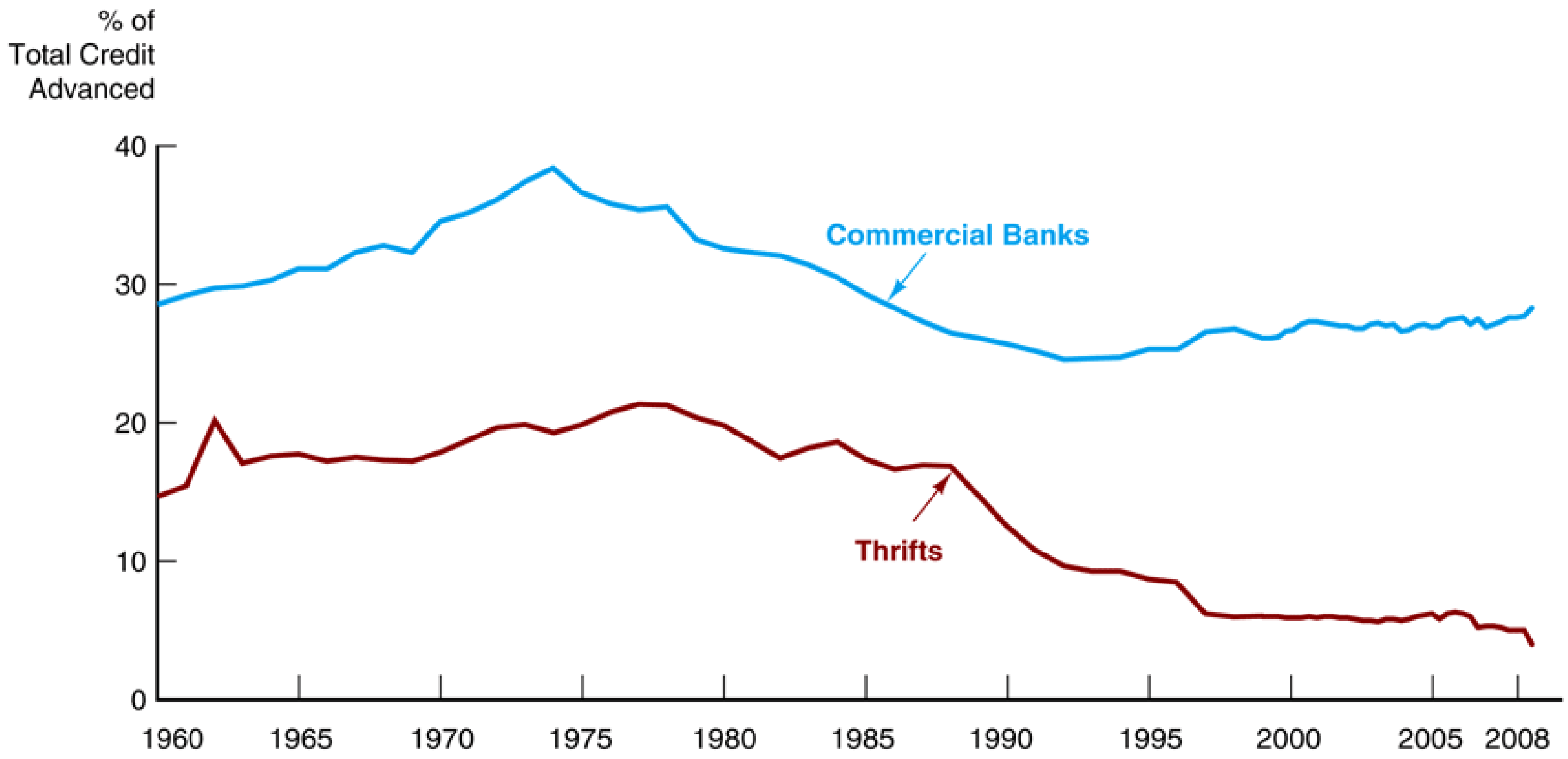
- S&Ls particularly hard hit, but many left as "zombie firms" (operating but insolvent) due to "regulatory forbearance" by regulators.

- Zombie S&Ls took on even greater risk in hope of digging out, leading to mounting losses.

- By end of 1986, S&L insurance fund (FSLIC) was going bankrupt.

- By 1989, thrift losses (S&Ls, credit unions, mutual savings banks) nearly $20 billion, and about 700 Fed insured S&Ls in need of reorganization and liquidation.

Bank Share of Total Nonfinancial Borrowing in U.S., 1960–2008



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

NOTE: Mishkin 12, Figure 2, p. 287

1982-1989: U.S. Bank Crisis
(Aftermath: Cleaning Up the Mess)

- **Reform Legislation 1989-1991**
  - More stringent bank capital (i.e., net worth) requirements
  - Closer supervision
  - Reform of regulatory authorities
- **1994 Until 2002: Restructuring**
  - Riegle-Neal Act of 1994
  - Gramm-Leach-Bliley Act of 1999
  - Sarbanes-Oxley Act of 2002

1994: Riegle-Neal Act

- Response to movement underway by states since 1985 to get around branching restrictions imposed by earlier legislation

- Overturned McFadden Act of 1927 prohibiting interstate branching

- Established basis for a true nation-wide banking system

1999: Gramm-Leach-Bliley Act

- Relaxed the provisions of 1933 Glass-Steagall Act requiring separation of commercial banking from securities brokering/dealing activities.
- Encouraged consolidation of banks & non-bank firms into “Financial Holding Companies” (FHC)
- Required compliance with 1977 Community Reinvestment Act as prerequisite for FHC status
- Raised new concerns about how to regulate these more consolidated, complex FHC organizations
- ***QUESTION:*** Could act have passed after Enron?

Sarbanes-Oxley Act (SOX) of 2002

- **U.S. legislative response** to spate of accounting scandals (Enron, WorldCom, Global Crossing, Adelphia Communications...) in 2000-2002

- **Compliance with comprehensive reform of accounting procedures required for publicly held companies**, to promote and improve the quality and transparency of financial reporting by internal and external auditors.

Sarbanes-Oxley Act (SOX) of 2002

- Companies must **"list and track performance of their material risks and associated control procedures."**
- CEOs are required to **vouch for the financial statements of their companies.**
- Boards of Directors must have Audit Committees whose members are **independent** of company senior management.
- Companies can no longer make loans to company directors.

SOX Act of 2002 … Continued

- SOX Act Essentially a response to **one** cause of the financial irregularities: failure by auditors, SEC, and other agencies to provide adequate oversight.

- Not clear how SOX Act prevents misuse of "off-balance-sheet activities" that are difficult to trace.

- Sox Act also does not address **other** key causes:
  - ***misaligned incentives*** (e.g., shift from cash to stock option compensation)
  - ***focus on short-run profits*** rather than longer-run profit performance.

Dodd-Frank Act of 2010

Direct response to financial crisis beginning in 2007, called "the most sweeping change to financial regulation in the U.S. since the Great Depression." Key provisions include:

- **consolidation** of regulatory agencies;
- establishment of oversight council to evaluate **systemic** risk;
- more comprehensive regulation of financial markets, including markets for **derivatives**;
- additional protection reforms for consumers and investors;
- Includes a weakened version of the ***Volker Rule*** due to Paul Volker (Fed Chair 1979-1987).

NOTE: Original Volker Rule re-instated prohibition against combining commercial banking and securities activities that was included in Glass-Steagall Act of 1933 but overturned by the GLB Act of 1999.