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

Presenter:

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Last Revised: 25 April 2011
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

<table>
<thead>
<tr>
<th>Assets</th>
<th>Number of Banks</th>
<th>Share of Banks (%)</th>
<th>Share of Assets Held (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $100 million</td>
<td>2,882</td>
<td>40.3</td>
<td>1.9</td>
</tr>
<tr>
<td>$100 million–$1 billion</td>
<td>3,755</td>
<td>52.6</td>
<td>11.4</td>
</tr>
<tr>
<td>$1 billion–$10 billion</td>
<td>425</td>
<td>6.0</td>
<td>12.8</td>
</tr>
<tr>
<td>More than $10 billion</td>
<td>84</td>
<td>1.2</td>
<td>73.9</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>7,146</strong></td>
<td><strong>100.00</strong></td>
<td><strong>100.00</strong></td>
</tr>
</tbody>
</table>


Note: Mishkin 12, Table 1, p. 290
### Ten Largest Banks in World (2008)

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


Note: Mishkin 12, Table 3, p. 303
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)
EMPIRICAL FACT 3:

Multiple overlapping regulatory agencies
## Principal Regulatory Agencies of the U.S. Financial System (Mishkin 2, Table 5, p. 47)

<table>
<thead>
<tr>
<th>Agency</th>
<th>Functions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities and Exchange Commission (SEC)</td>
<td>Requires disclosure of information, restricts insider trading</td>
</tr>
<tr>
<td>Commodities Futures Trading Commission (CFTC)</td>
<td>Regulates procedures for trading in futures markets</td>
</tr>
<tr>
<td>Office of the Comptroller of the Currency</td>
<td>Charters and examines the books of federally chartered commercial banks and imposes restrictions on assets they can hold</td>
</tr>
<tr>
<td>National Credit Union Administration (NCUA)</td>
<td>Charters and examines the books of federally chartered credit unions and imposes restrictions on assets they can hold</td>
</tr>
<tr>
<td>State banking and insurance commissions</td>
<td>Charter and examine the books of state-chartered banks and insurance companies, impose restrictions on assets they can hold, and impose restrictions on branching</td>
</tr>
<tr>
<td>Federal Deposit Insurance Corporation (FDIC)</td>
<td>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</td>
</tr>
<tr>
<td>Federal Reserve System</td>
<td>Examines the books of commercial banks that are members of the system, sets reserve requirements for all banks</td>
</tr>
<tr>
<td>Office of Thrift Supervision</td>
<td>Examines the books of savings and loan associations, imposes restrictions on assets they can hold</td>
</tr>
</tbody>
</table>
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)

- Bank of North America is chartered.
- Bank of the United States is chartered.
- Bank of the United States' charter is allowed to lapse.
- Second Bank of the United States is chartered.
- Andrew Jackson vetoes rechartering of Second Bank of the United States; charter lapses in 1836.
- Federal Reserve Act of 1913 creates Federal Reserve System.
- Banking Act of 1933 (Glass-Steagall) creates Federal Deposit Insurance Corporation (FDIC) and separates banking and securities industries.
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,...).
(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.
(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
(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.


NOTE: Mishkin 12, Figure 2, p. 287

  • 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.