Chapter 10
BANKING INDUSTRY: STRUCTURE AND COMPETITION

Historical Development of the Banking Industry

Outcome: Multiple Regulatory Agencies
1. Federal Reserve
2. FDIC
3. Office of the Comptroller of the Currency
4. State Banking Authorities

Structure of the Commercial Banking Industry

Branching Regulations
Branching Restrictions: McFadden Act and Douglas Amendments
Very anticompetitive
Response to Branching Restrictions
1. Bank Holding Companies
   A. Allowed purchases of banks outside state
   B. BHCs allowed wider scope of activities by Fed
   C. BHCs dominant form of corporate structure for banks
2. Nonbank Banks
   Not subject to branching regulations, but loophole closed in 1987
3. Automated Teller Machines
   Not considered to be branch of bank, so networks allowed

Bank Consolidation and Nationwide Banking
Bank Consolidation: Why?
1. Branching restrictions weakened
2. Development of super-regional banks
Riegle-Neal Act of 1994
1. Allows full interstate branching
2. Promotes further consolidation

Future of Industry Structure
Will become more like other countries, but not quite:
Several thousand, not several hundred

Bank Consolidation: A Good Thing?
Cons:
1. Fear of decline of small banks and small business lending
2. Rush to consolidation may increase risk taking
Pros:
1. Community banks will survive
2. Increase competition
3. Increased diversification of bank loan portfolios: lessens likelihood of failures

Separation of Banking and
Other Financial Service Industries

Erosion of Glass-Steagall
Fed, OCC, FDIC, allow banks to engage in underwriting activities
Gramm-Leach-Bliley Financial Services Act of 1999: Repeal of Glass-Steagall
1. Allows securities firms and insurance companies to purchase banks
2. Banks allowed to underwrite insurance and engage in real estate activities
3. OCC regulates bank subsidiaries engaged in securities underwriting
4. Fed oversee bank holding companies under which all real estate, insurance and large
   securities operations are housed
5. Banking insitutions become larger and more complex

Financial Innovation and Decline in Traditional Banking
Innovations Increasing Competition
1. Money market mutual funds
   Avoids deposit rate ceilings and reserve requirements
2. Junk bonds
   Result of better information in credit markets
3. Commercial paper market
   Result of better information in credit markets and rise in money market mutual funds
4. Securitization
   Result of better information in credit markets and computer technology

Decline in Traditional Banking
Loss of Cost Advantages in Acquiring Funds (Liabilities)
\[ i \uparrow \] then disintermediation because
1. Deposit Rate Ceilings and Regulation Q
2. Money Market Mutual Funds
3. Foreign banks have cheaper source of funds: Japanese banks can tap large savings pool
Loss of Income Advantages on Uses of Funds (Assets)
1. Easier to use securities markets to raise funds: commercial paper, junk bonds, securitization
2. Finance companies more important because easier for them to raise funds

Banks’ Response
Loss of cost advantages in raising funds and income advantages in making loans causes reduction in profitability in traditional banking
1. Expand lending into riskier areas: e.g., real estate
2. Expand into off-balance sheet activities
3. Creates problems for U.S. regulatory system
Similar problems for banking industry in other countries