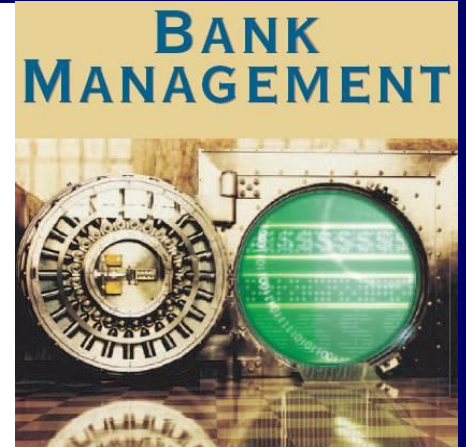


FUNDAMENTAL FORCES OF CHANGE IN BANKING

Lecture 1



Historical Bank Regulation

- **Definition of Commercial Bank**
 - **Accept demand deposits and make commercial loans.**
- **Limitations on:**
 - **Geographic Scope**
 - **Products and Services**

Goals and Functions of Bank Regulation

- **Ensure the Safety and Soundness of Banks**
- **Provide an Efficient and Competitive Financial System**
- **Provide Monetary Stability**
- **Maintain the Integrity of the Payments System**
- **Protect Consumers from Abuses**

Safe, Sound, Efficient & Competitive System

■ Supervision and Examination

■ CAMELS

- Capital
- Asset Quality
- Management Quality
- Earnings Quality
- Liquidity
- Sensitivity to Market Risk

Safe, Sound, Efficient & Competitive System

- **Supervision and Examination**
 - **Memorandum of Understanding**
 - **Formal regulatory document**
 - **Cease and Desist Order**
 - **Legal document**
 - **Has legal standing**

Safe, Sound, Efficient & Competitive System

■ New Charters

- Dual Banking System
- Office of the Comptroller of the Currency
 - Charters national banks
- Office of Thrift Supervision
 - Charters federal savings banks and savings associations
- National Credit Union Administration
 - Charters federal credit unions

Safe, Sound, Efficient & Competitive System

■ New Charters

- State Banking Authorities
 - Charter state banks
- State Savings Authorities
 - Charter state savings banks
- State Credit Union Authorities
 - Charter state credit unions

Safe, Sound, Efficient & Competitive System

- **National versus State Charter**
 - **All banks obtain FDIC deposit insurance as part of the chartering process**
 - **National banks must join the Fed**
 - **Primary regulator is the OCC**

Safe, Sound, Efficient & Competitive System

- **National versus State Charter**
 - **State banks may join the Fed**
 - **State banks are regulated by their state banking authority.**
 - **State banks also have a primary federal regulator**
 - **The primary federal regulator of state banks that are members of the Fed is the Federal Reserve**
 - **The primary federal regulator of Non-Fed member state banks is the FDIC**

Safe, Sound, Efficient & Competitive System

- **Commercial Banks, Savings Institutions, and Credit Unions**
 - **Commercial Banks**
 - Specialize in short-term business credit
 - **Savings Institutions**
 - Specialize in real estate loans
 - “Qualified Thrift Lender”
 - Unitary Thrift Holding Company
 - **Credit Unions**
 - “Common Bond” requirement

Safe, Sound, Efficient & Competitive System

- **Non-Depository Financial Companies**
 - **Brokerage houses**
 - **Mortgage companies**
 - **Insurance companies**
 - **Finance companies**

Safe, Sound, Efficient & Competitive System

■ Federal Deposit Insurance

- Depositors are currently insured up to \$100,000 per qualify account per insured bank
 - Original limit in 1933 was \$5,000
- FDIC maintains the deposit insurance fund at 1.25% of insured deposits.
- Currently, the fund is “well-funded” and over 90% of banks pay no insurance premium

Safe, Sound, Efficient & Competitive System

- **Shortcomings of Restrictive Bank Regulation**
 - **Does not prevent bank failure**
 - **Cannot eliminate economic risk**
 - **Does not guarantee that bank management will make good decisions**

Monetary Stability & the Payments System

■ The Federal Reserve System

■ Fundamental Functions

- Conduct monetary policy
- Provide and maintain the payments system
- Supervise and regulate banking operations

■ Organization

- Board of Governors
- 12 Federal Reserve District Banks

Monetary Stability & the Payments System

■ The Federal Reserve System

■ Monetary Policy Tools

■ Open Market Operations

- Open market purchases (sales) increase (decrease) reserves & the money supply

■ Discount Rate

- Decreasing (Increasing) the discount rate makes bank borrowing less (more) expensive, which leads to an increase (decrease) in the money supply

■ Reserve Requirements

- Decreasing (Increasing) reserve requirements increases (decreases) the money supply

Monetary Stability & the Payments System

- **Commercial Banks and the Economy**
 - **Banks are the primary conduit for monetary policy**
 - **Banks are the primary source of credit for most small businesses and many individuals**

Efficient and Competitive Financial System

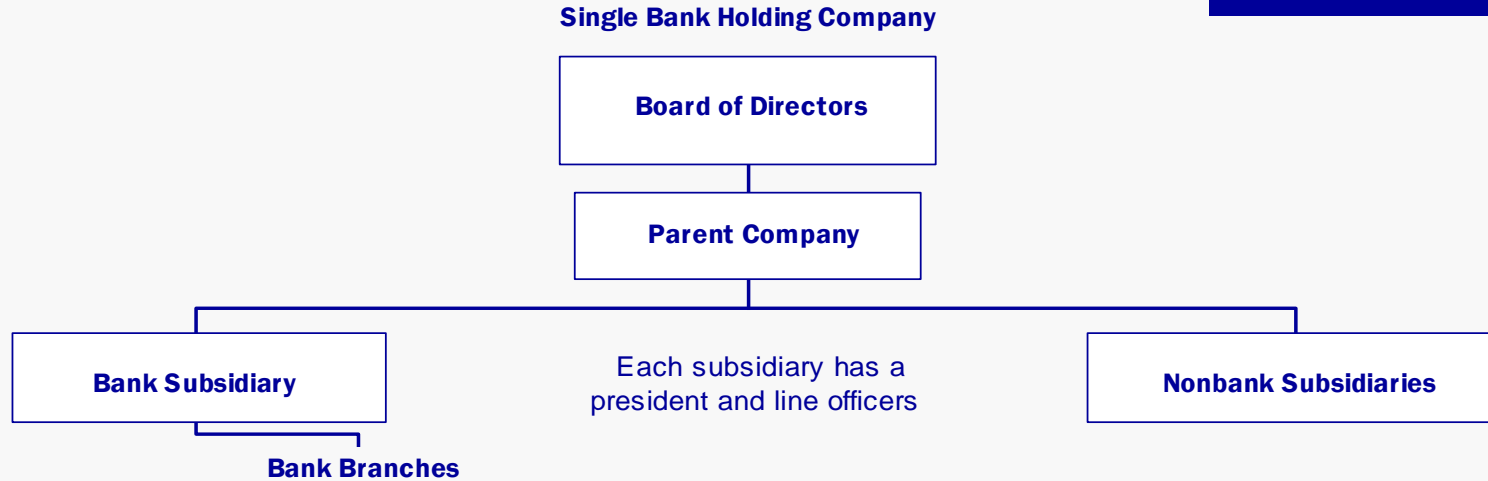
- **Organizational Form of the Banking Industry**
 - **Unit banking versus Branch banking**
 - **Branching and Interstate Expansion**
 - **Riegle-Neal Act**

Efficient and Competitive Financial System

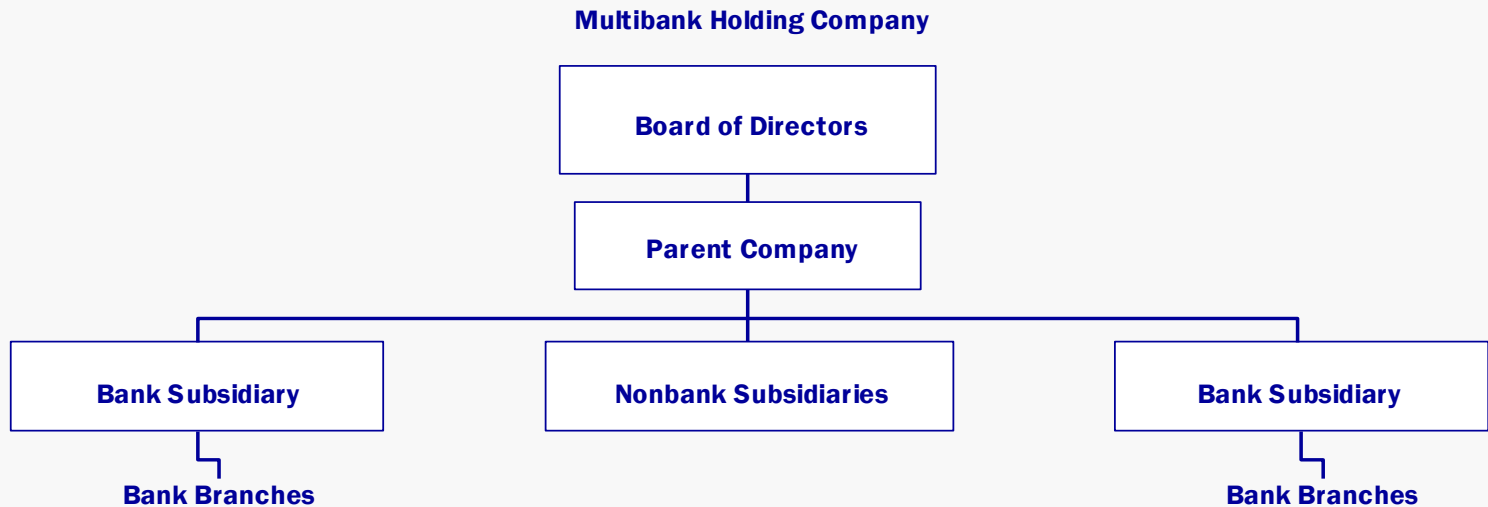
- **Organizational Form of the Banking Industry**
 - **Bank Holding Companies**
 - **Parent**
 - **Subsidiaries**
 - **One-Bank Holding Companies**
 - **Multi-Bank Holding Companies**

Exhibit 1.10

Organizational structure of the BHC



The bottom four levels have the same organizational form as the independent bank.

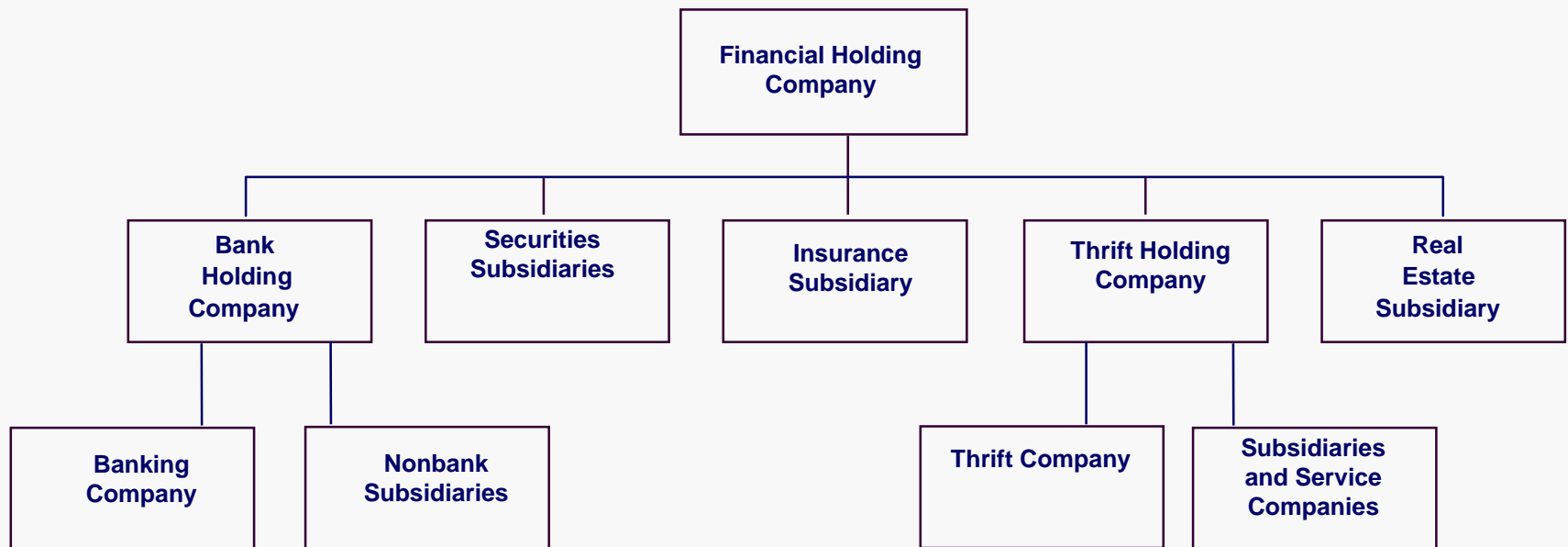


Efficient and Competitive Financial System

- **Organizational Form of the Banking Industry**
 - **Financial Holding Companies**
 - Can engage in financial activities not permitted in a bank or bank holding company
 - Federal Reserve may not permit a bank holding company to convert to a financial holding company if the bank holding company is not well capitalized, well managed, or did not receive a satisfactory rating on its most recent CRA exam.

Exhibit 1.11

Organizational structure of a financial holding company



Efficient and Competitive Financial System

- **Organizational Form of the Banking Industry**
 - **Holding Company Cash Flow**
 - **Parent company's net income is typically derived from dividends, interest, management fees from equity in subsidiaries, and interest paid on holding company debt.**
 - **Parent company typically pays little in income tax since 80% of dividends from subsidiaries is exempt.**

Efficient and Competitive Financial System

- **Organizational Form of the Banking Industry**
 - **Non-bank Activities Permitted By Bank Holding Companies**
 - **“Closely related to banking”**
 - *** Loans**
 - *** underwriting and brokerage**
 - *** consulting**
 - *** general management services**

Efficient and Competitive Financial System

- **Organizational Form of the Banking Industry**
 - **Mergers and Consolidations**
 - **Mergers must be approved, dependent on the classification of the surviving bank**
 - **OCC approves national bank mergers**
 - **State member banks by the Federal Reserve**
 - **State non-member banks by the FDIC**

Efficient and Competitive Financial System

- **Organizational Form of the Banking Industry**
 - **Mergers and Consolidations**
 - **Motivation for mergers and consolidation:**
 - **Cut costs**
 - **Improve profitability**
 - **Increase competitive position**
 - **Cross-sell financial products & services**

Consumer Protection

■ Reg. B

■ Equal Credit Opportunity

- Cannot discriminate on the basis of sex, race, marital status, religion, age, or national origin.

■ Reg. Z

■ Truth-in-Lending

- Requires disclosure of:
 - Effective interest rates, total interest paid, total of all payments
 - Why credit was denied

Trends in Federal Legislation & Regulation

■ Current Unresolved Regulatory Issues

■ Capital Adequacy

- Increased capital requirements make banks safer, from a regulator's perspective
- However, increasing capital requirements also has disadvantages:
 - Equity is more expensive than debt
 - Most banks do not have ready access to the equity markets
- This can lead to more consolidation

Trends in Federal Legislation & Regulation

- **Current Unresolved Regulatory Issues**
 - **Deposit Insurance Reform**
 - **Too Big to Fail**
 - **Should \$100,000 insurance limit be increased?**
 - **Non-bank Financial Services Companies**
 - **Should banks that lend to hedge funds, like Long-Term Capital Management, be required to hold additional capital?**

Trends in Federal Legislation & Regulation

- **Current Unresolved Regulatory Issues**
 - **New Powers**
 - **Req. Q still prevents banks from paying explicit interest on commercial demand deposit accounts**
 - **Most banks would like to be able to pay interest on commercial demand deposit accounts**
 - **What are the costs and benefits?**

Banking Business Models

- **Global Banks**
 - **International presence**
- **Nationwide Banks**
 - **Coast-to-coast presence**
- **Super-Regional Banks**
 - **Extensive operations in a limited geographic area of the U.S.**
- **Regional Banks**
- **Specialty Banks**

Exhibit 1.17 DISTRIBUTION OF THE NUMBER OF BANKS AND TOTAL ASSETS BY TOTAL ASSETS: 1995 - 2004

	Number of Banks	Assets Size			
		< \$100 M	\$100M - \$1B	\$1B - \$10B	> \$10B
1995	10,242	7,123 (69.55%)	2,741 (26.76%)	331 (3.23%)	63 (0.62%)
1997	9,451	6,147 (65.04%)	2,900 (30.68%)	331 (3.50%)	73 (0.77%)
1999	8,580	5,157 (60.10%)	3,029 (35.30%)	318 (3.71%)	76 (0.89%)
2001	8,080	4,486 (55.52%)	3,194 (39.53%)	320 (3.96%)	80 (0.99%)
2003	7,769	3,911 50.34%	3,434 44.20%	341 4.39%	83 1.07%
2004	7,630	3,655 (47.90%)	3,530 (46.26%)	360 (4.72%)	85 (1.11%)

	Total Assets	Asset Size			
		< \$100 M	\$100M - \$1B	\$1B - \$10B	> \$10B
1995	\$4,116	\$310 (7.54%)	\$668 (16.22%)	\$1,077 (26.17%)	\$2,061 (50.07%)
1997	\$4,642	\$277 (5.97%)	\$711 (15.32%)	\$995 (21.45%)	\$2,658 (57.27%)
1999	\$5,735	\$243 (4.23%)	\$755 (13.16%)	\$915 (15.96%)	\$3,823 (66.65%)
2001	\$6,569	\$222 (3.37%)	\$819 (12.47%)	\$915 (13.93%)	\$4,613 (70.22%)
2003	\$7,603	\$201 (2.64%)	\$910 (11.97%)	\$947 (12.46%)	\$5,545 (72.93%)
2004	\$8,413	\$189 (2.25%)	\$953 (11.33%)	\$973 (11.57%)	\$6,297 (74.85%)

Banking Business Models

- **Specialty Banks**

- **Also known as:**

- **Community Banks**

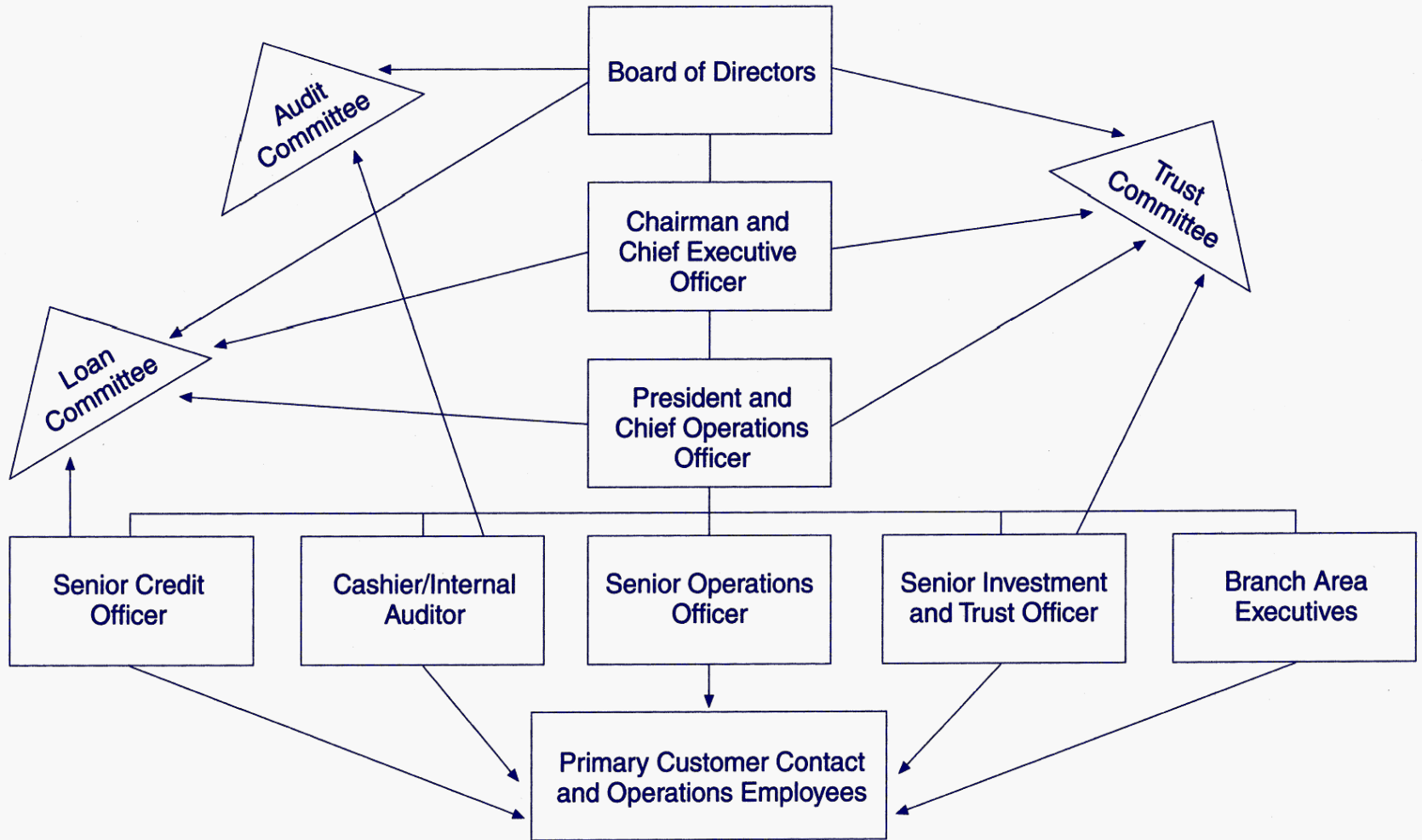
- **Independent Banks**

- **Typically have less than \$1 billion in assets**

- **Organization**

Exhibit 1.18

Organizational structure of an independent bank



Banking Business Models

■ Specialty Banks

■ Personnel

- Senior Credit Officer
- Cashier/Chief Financial Officer
- Senior Operations Officer
- Senior Investment Officer
- Branch Area Executive

Fundamental Forces of Change

- **Deregulation/Reregulation**
- **Financial Innovation**
- **Securitization**
- **Globalization**
- **Advances in Technology**

Fundamental Forces of Change

Role of Regulation

- **Regulatory Dialectic**
 - **Process of regulation, market response, and reregulation**
- **Financial Innovation**

Fundamental Forces of Change

Increased Competition

■ For Deposits

- Interest rate ceilings and inflation

■ For Loans

- Commercial paper
- Junk bonds
- Credit scoring
- Credit derivatives

Fundamental Forces of Change: Off-Balance Sheet Activities

- **Loan Commitments**
- **Loan guarantees**
- **Standby Letters of Credit**
- **Interest Rate Swaps**
- **Futures, Forwards & Options**
- **Leases**

Fundamental Forces of Change: Impact of Nonbank Competition

- **Captive Finance Companies**
- **General Finance Companies**
 - **Fund their loans by issuing commercial paper and long-term bonds. Their cost of funds is higher than a bank's, but they charge higher rates.**

Fundamental Forces of Change: Competition for Payments Services

- **Credit Cards**
- **Debit Cards**
- **Prepaid Cards**
- **CHIPS**
- **ACH**

Fundamental Forces of Change: Competition for Other Bank Services

- **Trust Services**
- **Brokerage Services**
- **Data Processing**
- **Real Estate Appraisal**
- **Credit Life Insurance**
- **Personal Financial Consulting**

Fundamental Forces of: Change Investment Banking

- **National Full-Line Firms**
- **Investment Banking Firms**
- **Underwriter**
 - **Underwriter syndicate**
- **Broker versus Dealer**

Fundamental Forces of Change: Deregulation and Re-regulation

■ Deregulation

- Eliminating existing regulations**

■ Reregulation

- Implementing new restrictions on banking activities**

Fundamental Forces of Change: Financial Innovation

- **Innovation may be caused by a bank wanting to:**
 - **Enter into a new geographic market**
 - **Enter into a new product market**
 - **Deliver services less expensively**
 - **Etc.**

Fundamental Forces of Change: Securitization

- **Securitization**
 - **The process of converting assets into marketable securities**
 - **Mortgages**
 - **Credit card receivables**

Fundamental Forces of Change: Globalization

■ Globalization

- Is the evolution of markets and institutions where geographic boundaries do not restrict financial transactions or competition

Fundamental Forces of Change:

Technology

■ Advances in Technology

- Advances in technology increase the scope of the global market place and competition
- Advances in technology also reduce the need for an intermediary by providing easy access to information
 - Increasing competition by reducing the cost of being an information intermediary