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Abstract

This paper gives an overview of the banking sector in the United States of America; it highlights the reforms since the late 19th century; it tracks the growth of the banking sector in response to the reforms implemented over the past seven decades; and finally, it highlights the challenges facing the banking sector in the US. The country's banking sector consists of more than 6300 commercial banks and other significant authorised deposit-taking institutions, with the Federal Reserve System as the country's central bank, at the apex. Since the 1930s, the US government has implemented a number of banking sector reforms – in order to safeguard and improve the banking sector. The response to these reforms, by the banking sector, has been varied. By any standard, the US currently has one of the most developed banking systems in the world. The country has enjoyed a substantial bank-based financial sector development over the years, and its institutional framework has also grown stronger. However, as developed as it is, the US banking system has its own challenges. These include prolonged low interest rates, increasing non-performing asset levels, weak economic growth, fiscal policy uncertainties and the threat of contagion from Europe.

Keywords: USA, banking sector development, financial reforms.
JEL Classification: G20, G21, G28.

Introduction

Banks play a central role in the development of every economy by mobilizing resources for productive investments, and by being the conduit for the implementation of monetary policy (Sanusi, 2011). The role of banks in economic development is widely acknowledged in the literature. In particular, Schumpeter (1911) put the role of financial intermediation at the center of economic development. He argued that financial intermediation, through the banking system, plays a pivotal role in economic development; and it does this by influencing the allocation of savings, thereby improving productivity, technical change and the rate of economic growth.

In support of the importance of banks in the economic growth of a country, Boyd and Prescott (1986) modelled the critical role that banks play in easing information frictions, and thereby improving resource allocation. Stiglitz (1985) and Bhide (1993) also stressed that stock markets will not produce the same improvement in resource allocation and corporate governance as banks. In a separate study, King and Levine (1993) show that bank development helps to explain economic growth. Levine (1999) and Levine, Loayza, and Beck (2000) confirmed this finding. The endogenous growth literature also supports the argument that financial development has a positive impact on growth (Bencivenga and Smith, 1991).

In the light of these functions, it may confidently be stated that banks have a positive impact on growth. In the U.S., banks have historically been viewed as playing a special role in the financial sector – for two reasons. One is that they perform a critical role in facilitating payments. The other is that they have long played an important, although arguably less exclusive, role in channelling credit to households and businesses. By developing expertise, as well as diversifying across many borrowers, banks reduce the costs of supplying credit (Samolyk, 2004).

Large banks in the US provide unique contributions to the US economy, including unique products and services, economies of scale, and the promotion of innovation (The Clearing House, US, 2012). Although the US has one of the most developed and sophisticated financial sectors in the world, its development, as in some other developed countries, is largely driven by the market-based segment. Thus, the market-based segment tends to overshadow the bank-based segment. As a result, despite the important role banks play in the economic development of the US, the US banking sector has not received adequate coverage in terms of research (Benmelech and Moskowitz, 2010; Murphy, 2012). The documentation of the US bank-based segment of the financial sector is very scanty.

The objective of this paper is to put the US banking sector in the spotlight – by providing an overview of the country's banking sector, its reforms, growth and challenges – since the late 19th century, and through to 2011. This is achieved by reviewing different pieces of literature on the US banking system and condensing relevant literature in one document, thereby bringing out a full picture of the US banking system. In explaining the trends, raw data from various reliable sources (including US financial regulatory institutions and the World Bank) was analyzed.

The contribution of the paper is in putting together, in a chronological order, the evolution of the US banking system over five decades, highlighting important trends – to give a full picture of the US

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banking system – something that has not been done before, to our knowledge. What existed before were pieces of literature covering selected topics and policies, which made it difficult for readers to have a full picture of the US banking system without going through a heap of literature.

The rest of this paper is organized as follows. Section 1 gives an overview of the bank-based financial system in the US. Section 2 outlines reforms implemented to revitalize the banking sector. Section 3 tracks the growth of the banking sector in the US, in response to the reforms. Section 4 highlights the challenges facing the development of the bank-based financial sector in the US. The final section concludes the paper.

1. The origin of the bank-based financial system in the USA

The Federal Reserve System, often referred to as the Federal Reserve, or simply "the Fed", is the central bank of the United States. The history of central banking in the US dates back to as early as the late 18th century, with the establishment of the first central bank, the First Bank of the United States (BUS) in 1791, headquartered in Philadelphia (Federal Reserve Bank of New York, 2012a).

The Bank performed the basic banking functions of accepting deposits, issuing bank notes, making loans and purchasing securities. As a result of its influence, the Bank was of considerable use to both American commerce and the federal government. The Bank's charter ran for twenty years; and when it expired in 1811, a proposal to renew the charter failed. Chaos quickly ensued; and this was exacerbated by the War of 1812, and by the lack of a central regulating mechanism over banking and credit (New York Fed, 2012).

The situation deteriorated to such an extent that in 1816, a second Bank of the United States was chartered. This bank was similar to its predecessor, in that it wielded immense power; and when its charter expired in 1836, it was not renewed. According to the New York Fed (2012a), for the quarter century that followed, America's central banking was carried out by a myriad of State-chartered banks with no federal regulation. The National Banking Act of 1863 sought to add clarity and security to the banking system by introducing and promoting currency notes issued by nationally chartered banks, rather than those issued by State-chartered ones (New York Fed, 2012a).

In 1907, a severe financial panic jolted Wall Street and forced several banks into failure. This panic, however, did not trigger a broad financial collapse; but it was a sign that the economy's banking structure was out of date and in need of major reform (New York Fed, 2012a). In December 1912, the Glass-Willis proposal was submitted to the President-elect. The proposal called for the creation of privately controlled regional reserve banks, which would hold a portion of member banks' reserves, perform other central banking functions, and issue currency against commercial assets and gold. The President-elect approved of this idea, but also insisted on the creation of a central board to control and coordinate the work of the regional reserve banks (New York Fed, 2012a).

In 1913, the Federal Reserve Act incorporated some modifications, which allowed for the introduction of the regional Federal Reserve System (Federal Reserve Bank of Boston, 2012). The Federal Reserve's responsibilities include: (1) conducting the nation's monetary policy; (2) supervising and regulating banks and other important financial; (3) maintaining the stability of the financial system and containing any systemic risk that might arise in financial markets; and (4) providing certain financial services to the US government, US financial institutions, and foreign official institutions, and playing a major role in operating and overseeing the nation's payment systems (Federal Reserve Bank, 2012a).

The American banking industry is governed by, among other acts, the National Banking Acts of 1863 and 1864; the Banking Act of 1933; the Depository Institutions Deregulation Act of 1980 and the Garn-St. Germain Depository Institutions Act of 1982. Federal Reserve regulations also play a role in banking regulation. The American banks are also regulated, in accordance with the principles set by the Basel Committee on Banking Supervision. According to the Bank of International Settlement (2003, p. 433), the legal framework governing payment activity in the United States is complex. While most countries have only one bank regulator, in the US banking is regulated at both the federal and state level.

Among the regulators are the Office of the Comptroller of the Currency and the Office of Thrift Supervision that serve to regulate and supervise all national banks and the federal branches and agencies of foreign banks in the United States. The banking system is one of the oldest, largest, and most important of the economy's industries (Sylla, 2012). The Federal Deposit Insurance Corporation (FDIC), which is a United States government corporation created by the Glass-Steagall Act of 1933, is part of the banking system in the United States. It provides deposit insurance, which guarantees the safety of deposits in member banks (FDIC, 2012a).

Although the operations of individual banks are similar throughout the world, the structure and operation of the US banking industry, as a whole, is

strikingly different from that of other banking sectors. In most countries, four or five large banks typically dominate the banking industry; but in the United States there are 6,291 commercial banks, 1,500 savings and loan associations, 400 mutual savings banks, and 10,000 credit unions FDIC, 2012b). The total number of banks has, however, declined, falling from 14,210 in 1986 to 9,520 in 1996; and then further to 7,401 in 2006 – before reaching a 6,291 mark in December 2011. The fall in the number of banks during the 2000s was mostly as a result of the late-2000's financial crisis that was considered, by many economists, to be the worst financial crisis since the Great Depression of the 1930s (FDIC, 2012b).

According to Terrell and Key (2012, p. 54), one of the most significant recent developments in both international banking, and the structure of banking within the United States, has been the rapid growth in the activities of foreign banks in the United States. The US offices of foreign banks currently offer a broad range of banking services to both foreign and domestic customers; and their increasing importance in the US markets has resulted in various legislative proposals to establish a uniform Federal policy concerning their activities (Terrell and Key's, 2012; Federal Reserve Bank, 2012b).

2. Bank-based financial reforms in the USA

The modern commercial banking industry in the United States began when the Bank of North America was chartered in Philadelphia in 1782 (Federal Reserve Bank of Philadelphia, 2012b). With the success of this bank, other banks opened for business; and the American banking industry was up and running. The need for a greater centralized control gave birth to the Bank of the United States (BUS) in 1791. The Congress created the Second Bank of the United States in 1816; but it was never re-chartered after the expiry of its charter in 1836 (New York Fed, 2012a).

According to Mitchener and Jaremski (2012), banking regulations were extremely lax in many States during the second half of the 19th century. The National Bank Act of 1863 (and subsequent amendments to it) created a new banking system of federally chartered banks (called national banks), which were supervised by the Office of the Comptroller of the Currency, a department of the US Treasury (Mitchener and Jaremski, 2012).

In 1913, the Federal Reserve Act was passed, creating the central bank of the country, in the name of the Federal Reserve System (the Fed), to promote an even safer banking system. All national banks were required to become members of the Federal Reserve System, and then became subject to a new set of regulations issued by the Fed. Although the Fed enhanced financial stability, it did little to ease the liquidity problems of the banks in the 1930–1933 period (FDIC, 2012c, p. 33). In the wake of the Depression of the early 1930s, a number of important banking reforms were ushered in. Among the reforms was the Banking Act of June 1933, often called the Glass-Steagall Act, which introduced federal deposit insurance, federal regulation of interest rates on deposits, and the separation of commercial banking from investment banking. The federal insurance for deposits was, and still is, administered by the Federal Deposit Insurance Corporation (FDIC). The purchase of FDIC insurance, however, made banks subject to another set of regulations imposed by the FDIC. The United States was the first country to officially enact deposit insurance (FDIC, 2012a).

Two years later, the Banking Act of 1935 was passed, essentially creating the Fed, as it is known today (Sylla, 2012). It strengthened the central bank's powers and made them less decentralized than they had been during the Fed's first two decades (Sylla, 2012). In 1978, the International Banking Act of 1978 was passed. According to PricewaterhouseCoopers (2007/2008), the Act was a landmark piece of legislation, which, for the first time, established a framework for Federal regulation of foreign-banking activities in the US, giving foreign banks a national treatment

In 1982, the Germain Depository Institutions Act of 1982 was introduced in the context of a crisis among thrifts (Tregenna, 2009). In Tregenna's view, the Act allowed banks to purchase failing banks across State lines, facilitating a rise in bank concentration. The legislation also abolished statutory restrictions on real estate lending by national banks and loosened the limits on loans to single borrowers. By 1986, regulations on setting maximum rates on deposit accounts had been phased out, and regulations inhibiting competition between different types of depository institutions in different markets and products were relaxed.

In 1994, the Riegle Community Development and Regulatory Improvement (CDRI) Act overhauled the regulatory structures and processes by means of an overall deregulatory effect (FFIEC, 2012). The Congress removed long-standing restrictions on interstate banking. Bank mergers were increasingly allowed. Today, the country has far fewer independent banks than in the past (FDIC, 2012b).

In 1999, the Congress passed the Gramm-Leach-Bliley Act (GLBA) of 1999 (also known as the Financial Services Modernization Act) that repealed the Glass-Steagall Act of 1933, that had effectively separated commercial and investment banking

(United States Government Printing Office, 2012). The business of banking, long stifled by regulation, was suddenly revived. Banks were no longer limited in their lending by the size of their deposit bases. In the early 2000s, cheap credit led to a housing and commercial real estate boom that turned into a bubble. Unlike the 1930s, depositors did not panic and rush to withdraw their funds from banks, because of deposit insurance. In 2007-2008, market funding for banks dried up, marking the beginning of the late 2000s financial crisis. However, massive interventions by the Fed and the US Treasury prevented a catastrophic banking and financial crisis similar to that of the early 1930s (Sylla, 2012).

Between 2008 and 2010, the FDIC insurance was expanded, due to the 2008 financial crisis, with insurance limit increasing to $250,000. With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, this increase became permanent, as of July 21, 2010.

In 2010, the 111th United States Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Public Law 111-203), signed into federal law by the President on July 21, 2010 (United States Government Printing Office, 2012). Passed as a response to the late-2000s recession, the Act brought the most significant changes to financial regulation in the United States since the regulatory reform that followed the Great Depression. It made changes in the American financial regulatory environment that affected all federal financial regulatory agencies and almost every aspects of the nation's financial services industry (Library of Congress, 2012).

As with other major financial reforms, a variety of critics have attacked the law, some arguing it was not enough to prevent another financial crisis or more "bail outs", and others arguing it went too far and unduly restricted financial institutions. The "Durbin Amendment", which is a provision in the final bill aimed at debit card interchange fees and increasing competition in payment processing, was passed. The bill aimed to restrict anti-competitive practices and encourage competition, and included provisions, which allow retailers to refuse to use cards for small purchases and offer incentives for using cash or another type of card. The "Durbin Amendment" also gave the Federal Reserve the power to regulate debit card interchange fees, setting it at 12 cents per debit card transaction (Federal Reserve Bank, 2010).

3. Banking sector growth in the USA

In colonial America, there were no modern banks. Colonial Americans gave credit to each other, or relied on credit from merchants and banks in Great Britain (Sylla, 2012). Money consisted of foreign coins and paper money issued by the governments of each colony (Sylla, 2012). As late as 1781, there were no American banks.

In 1782, the new nation's first bank, the Bank of North America located in Philadelphia, was chartered by Congress. Three years later, Boston merchants founded the Massachusetts Bank. During the same period, the Bank of New York was founded. By 1789, these were the only three banks in the United States. They were local institutions, and not part of a banking system in which banks routinely receive and pay out one another's liabilities (Sylla, 2012).

During the 1790s, the federal revenue system was implemented. During the same period, the Treasury defined the US dollar in terms of gold and silver coins; these served as reserves backing bank money as banks proliferated. The national bank was also founded, called the Bank of the United States (BUS). The BUS prompted State legislatures to charter more banks – there were about thirty of these by 1800, more than 100 by 1810, 500-600 by the 1830s, and 1500-1600 on the eve of the Civil War. These banks were corporations, and the States also chartered many non-bank business corporations.

According to Sylla (2012), a distinctly modern US financial system did not exist in the 1780s, but was firmly in place by the mid-1790s, after which it expanded rapidly to serve, even foster, the rapid growth of the US economy. The banking system was a key component of this growth (Sylla, 2012). Failure to renew the BUS led to the formation of the second BUS in 1816 (New York Fed, 2012a). Just like the first, the second BUS federal charter was not renewed upon its expiry in 1836.

By the 1830s, to get away from the politicization involved in legislative chartering, a few States began to enact "free banking" laws (Hammond, 1957). These general incorporation laws made the granting of bank charters an administrative rather than a legislative function of government. This increased the access of Americans to banking. Without a central bank to oversee banking and finance, the expanding banking system of the 1830s, 1840s, and 1850s suffered from major problems, even though it supplied the country with ample loans to finance economic growth. One problem was the financial instability leading to banking crises in 1837, 1839-1842, and 1857.

A significant number of these banks failed when borrowers defaulted on their loan payments. The banking crises led to business depressions with high unemployment rates (Norton, 2012). Another problem was a chaotic currency. According to Sylla (2012), in those days, the government provided only coins; while bank notes were issued by individual banks. Hence, throughout the United States there circulated thousands of different-looking bank notes.

In 1863, Abraham Lincoln's Union government solved the problem by getting the Federal Government back into the business of chartering banks. The new national banks would issue a uniform national currency printed by the government and backed by US bonds. National bank currency was safer than State bank notes. Discounts on bank notes, a problem of the previous era, disappeared, improving the national payments system (Sylla, 2012).

The United States had what came to be called a "dual banking system" of national and State banks, and the system persisted into the 21st century. National bank notes, however, disappeared in the 1930s, replaced by today's national currency, the Federal Reserve Notes. From 1863 to 1913, the country continued to be without a central bank. It had a uniform national currency, and a better banking system than the one before 1863, but it was still prone to financial instability. Banking panics occurred in 1873, 1884, 1893, and 1907 (Sylla, 2012).

There were about 20,000 banks in 1907, and about 30,000 by the early 1920s. US bank deposits comprised more than a third of the total world deposits; and approximately the same as the combined deposits of German, British, and French banks – the next three largest systems (Sylla, 2012).

In 1913, after three-quarters of a century without a central bank and a period punctuated by a number of banking crises, the Federal Reserve System (the Fed) was created. The Fed was organized in 1914, comprising 12 regional Reserve Banks, co-ordinated by the Federal Reserve Board in Washington DC (Federal Reserve Bank of Boston, 2012). The Fed further improved the payment system by operating a national cheque-clearing system. It also introduced Federal Reserve Notes, making the national currency more uniform. The Fed also had the power to expand and contract its currency and credit, which served to reduce seasonal fluctuations in interest rates, thereby enhancing economic stability.

In the wake of the Great Depression, President Franklin Roosevelt's "New Deal" administration sponsored a number of important banking reforms that ushered in a long period of banking stability – lasting from the 1930s to the 1980s. That stability, however, was purchased at the cost of making American banking less competitive, less innovative, and more regulated than it had been before the 1930s. Banks and their political supporters responded by calling for deregulation – leading to the repeal of ceilings on deposit interest rates in the 1980s (Sylla, 2012).

In retrospect, deregulation may have led banking to become too exciting for its own good and that of the country (Sylla, 2012). In the early 2000s, cheap credit led to a housing and commercial real-estate boom that turned into a bubble – leading to the global financial crises during the late 2000s. This crisis saw further reduction in the total number of banks in the United States, as many large banks collapsed (FDIC, 2012b).

Table 1 is a comparison of the number of FDIC-insured commercial banks, branches and the total number of offices in the United States in 1970 compared with the period of 2000-2011. It also shows a precipitous and continuous drop in the number of banks between 1970 and 2000. After 2000, the number of banks still dropped, but modestly. The fall in the number of institutions was due to failures and to consolidation through mergers and acquisitions.

Table 1. The number of FDIC-insured commercial banks, branches and total number of offices in the US (1940-2011)

Year	Institutions	Branches	Offices
1970	13,511	21,839	35,350
2000	8,315	64,900	73,215
2001	8,082	65,667	73,749
2002	7,888	66,940	74,828
2003	7,770	68,258	76,028
2004	7,631	70,892	78,523
2005	7,526	73,510	81,036
2006	7,401	76,568	83,969
2007	7,284	79,126	86,410
2008	7,088	82,910	89,998
2009	6,840	83,041	89,881
2010	6,530	82,572	89,102

Source: FDIC (2012b).

The development of the American banking sector is also reflected by the growth in private sector credit. The period from 1975 to 1981 was characterized by almost constant credit provided by the financial institutions to the private sector, averaging 120% of GDP. Thereafter, private sector lending increased to 150% until 1987, when it became constant again, only toimprove three years later.

Historically, between 1975 and 2011, private sector lending reached an all-time low, of 115.2%, in 1981; and an all-time high, of almost 250%, in 2007 (World Bank, 2012). Figure 1 shows the trends in the banking sector growth, in the United States during the period of 1975-2012.

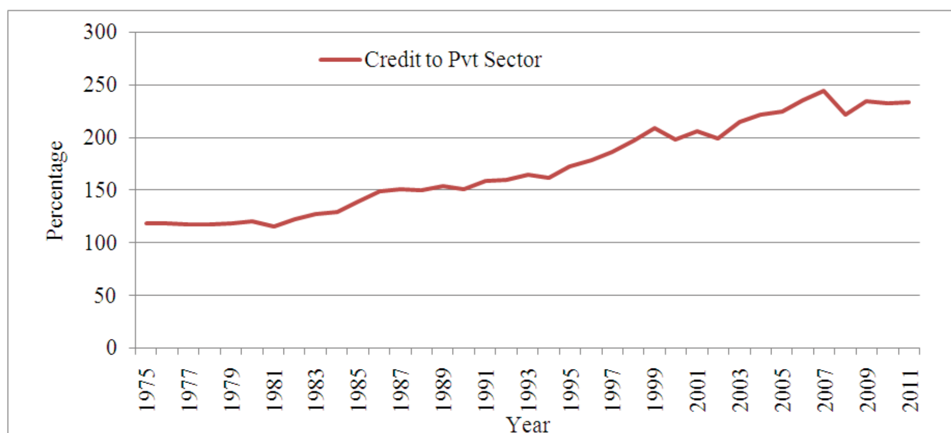

Fig. 1. Trends in banking sector growth in the US (1975-2012)

Source: World Bank Development Indicators (2012).

Non-performing loans, though generally low, have been on the increase since 2008. Credit information is easily available to both consumers and banking institutions. Both consumers and institutions have strong legal rights. Table 2 shows some of the banking indicators portraying the development of the US banking sector.

Table 2. Growth of banking sector in the United States (2000 - 2011)

Year	Bank non-performing loans to total gross loans (%)	Credit depth of information index (0 = low to 6 = high)	Strength of legal rights index (= weak to 10 = strong)
2000	1.1	-	-
2001	1.3	-	-
2002	1.4	-	-
2003	1.1	-	-
2004	0.8	6	9
2005	0.7	6	9
2006	0.8	6	9
2007	1.4	6	9
2008	3	6	9
2009	5.4	6	9
2010	4.9	6	9
2011	4.7	6	9

Source: World Bank Development Indicators (2012).

The growth of the American banking sector can also be portrayed by the increasing number of Automated Teller Machines (ATMs). The number of ATM terminals has risen steadily over the years; from 352,000 ATMs in 2002 to 396,000 in 2005, to 425,010 in 2008, and slightly down to 403,000 in 2009 (United States Department of State, 2012).

4. Challenges facing bank-based financial development in the USA

Although the US banking sector is recovering from the late 2000s financial crisis, it is far from being fully recovered; and it still faces a number of challenges that include: increasing non-performing asset levels, weak economic growth, fiscal policy uncertainties – and the threat of contagion from Europe.

According to the Federal Reserve Bank (2012c), one of the challenges facing the US banking sector at the moment is the shrinking mortgage market. Home ownership rates have declined because fewer households have chosen, or have been able, to become new homeowners in recent years. Data show that the pace of mortgage lending has fallen considerably on a national basis; the extension of first-lien mortgages to purchase homes fell by more than half from 2006 to 2011, and now stands at the lowest level since 1995 (Federal Reserve Bank, 2012c). According to the Federal Reserve Bank (2012c), the reduction in mortgage originations and home purchases for all groups relative to the pre-crisis period partly reflects the weakness in the effective demand for housing, rather than the unavailability of mortgage credit.

Another challenge facing the U.S. banking system, in the view of the Federal Reserve Bank of New York (2012b), is the "too-big-to-fail (TBTF)" challenge, since there are some very big banks whose failure, if they were allowed to fail, would be catastrophic. The Federal Reserve Bank of New York (2012b) further states that the market's belief that a TBTF firm is more likely to be rescued in the event of distress than other firms, weakens the degree of market discipline exerted by capital providers and their counterparts.

Although a number of policy measures that alter incentives and reduce the probability of distress have been put in place, they only help to reduce the chances of TBTF from occurring; but they do not completely eliminate the problem (Federal Reserve Bank of New York, 2012b). Although non-performing loans in the US banking sector are low, compared with those in the emerging economies, they have been on an upward trend in the last few years, compared with the country's historical statistics.

According to IMF (2012), the weak economic growth in the US poses a challenge to the country's banking sector. During such times when economy recovery is patchy and growth is below its potential, banks have difficulty in coming up with cutting-edge strategies for survival. Capital is also a challenge, as banks would need more capital to support additional lending – as part of the ongoing economic recovery – to meet stiffer regulatory requirements in the future, and to withstand any future shocks to their balance sheets (IMF, 2012). Since the US is among the world-leading economies, its banking system is open to the international world, making it prone to the not-so-favourable/harsh conditions prevailing in other economies. Currently, the US banking sector is threatened by the contagion from Europe.

Conclusions

This paper has given an overview of the banking sector in the US; it has highlighted the reforms since the 1930s; it has tracked the growth of the banking sector in response to the reforms implemented over the past seven decades; and it has highlighted the challenges facing the banking sector in the US. Since the great depression of the 1930s, the US Government has implemented a number of reforms, in order to safeguard and improve the country's banking sector, and to avoid banking crises of similar magnitude as that of the 1930s. These reforms have focused on securing the depositors money during bank failures; they have increased risk-management procedures, and enhanced corporate governance, as well as increased liquidity management, to enable the banking sector to contribute effectively to the development of the real sector through its intermediation process. In addition, these reforms have also involved a process of substantially improving the regulatory and surveillance framework, fostering healthy competition in banking operations. Although the banking sector has responded positively to some of these reforms, it still faces a number of challenges. These challenges include increasing non-performing asset levels, weak economic growth, and the threat of contagion from Europe.

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