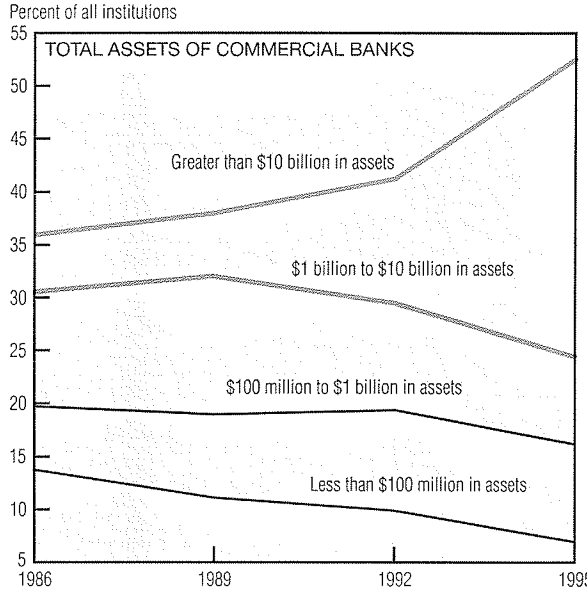
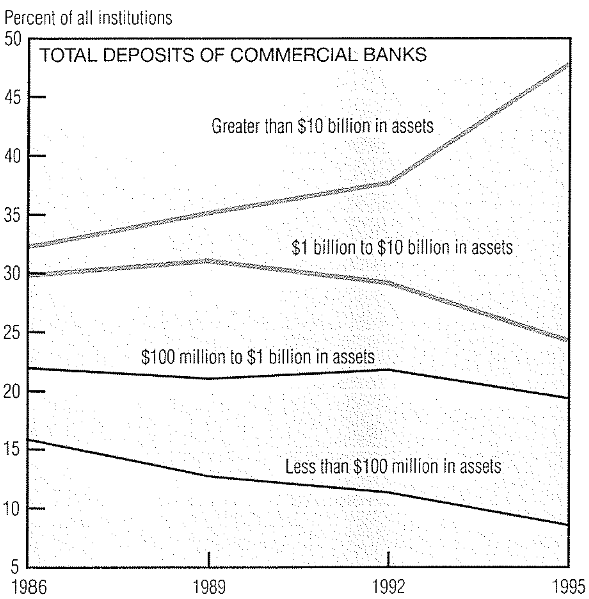
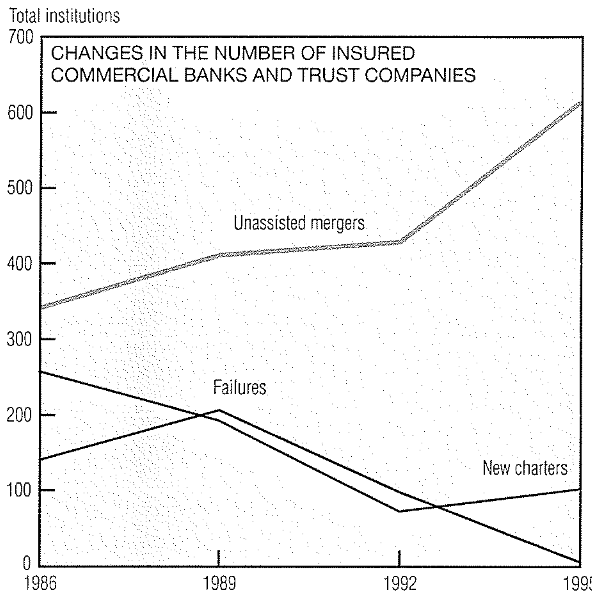
Banking Conditions

FDIC-Insured Commercial Banks by Asset Size
(Number)

	1986	1989	1992	1995
All institutions	14,181	12,707	11,462	9,941
Less than $100 million	11,394	9,722	8,291	6,659
$100 million to $1 billion	2,448	2,607	2,791	2,861
$1 billion to $10 billion	306	334	329	346
Greater than $10 billion	33	44	51	75







NOTE: Boundaries used to separate institutions by asset size are expressed in nominal terms, creating a distortion in the comparisons over time.
SOURCE: Federal Deposit Insurance Corporation.

The consolidation of the banking industry that began in the mid-1980s has been driven primarily by changes in the regulations on banks' geographic expansion.

At the beginning of the century, most states required banks to be unit banks, that is, to have only one office. In time, states began to allow intrastate branching, but continued to prohibit interstate branching and the acquisition of local banks by out-of-state banks. In the 1950s, banks attempted to avoid this prohibition by developing bank holding companies (BHCs) with banks located in various states. However, in 1956 the Douglas Amendment to the Bank Holding Company Act stopped this initiative. It prohibited a BHC from acquiring a bank outside the company's home state without authorization from the target bank's state.

Restrictions on banks' geographic expansion had pushed their number to a post-Depression high of about 14,500 in 1984, when regulatory barriers on interstate banking began to fall. States started to allow out-of-state BHCs to acquire home-state banks, but maintained the ban on interstate branching; that is, they did not allow the acquired banks to be converted into branches of the out-of-state banks. In parallel with these regulatory changes, the number of banks steadily dropped, mainly because of increased merger activity.

One implication of banking consolidation, particularly in the 1990s, is the greater importance of the largest institutions. Their number has increased significantly, as has

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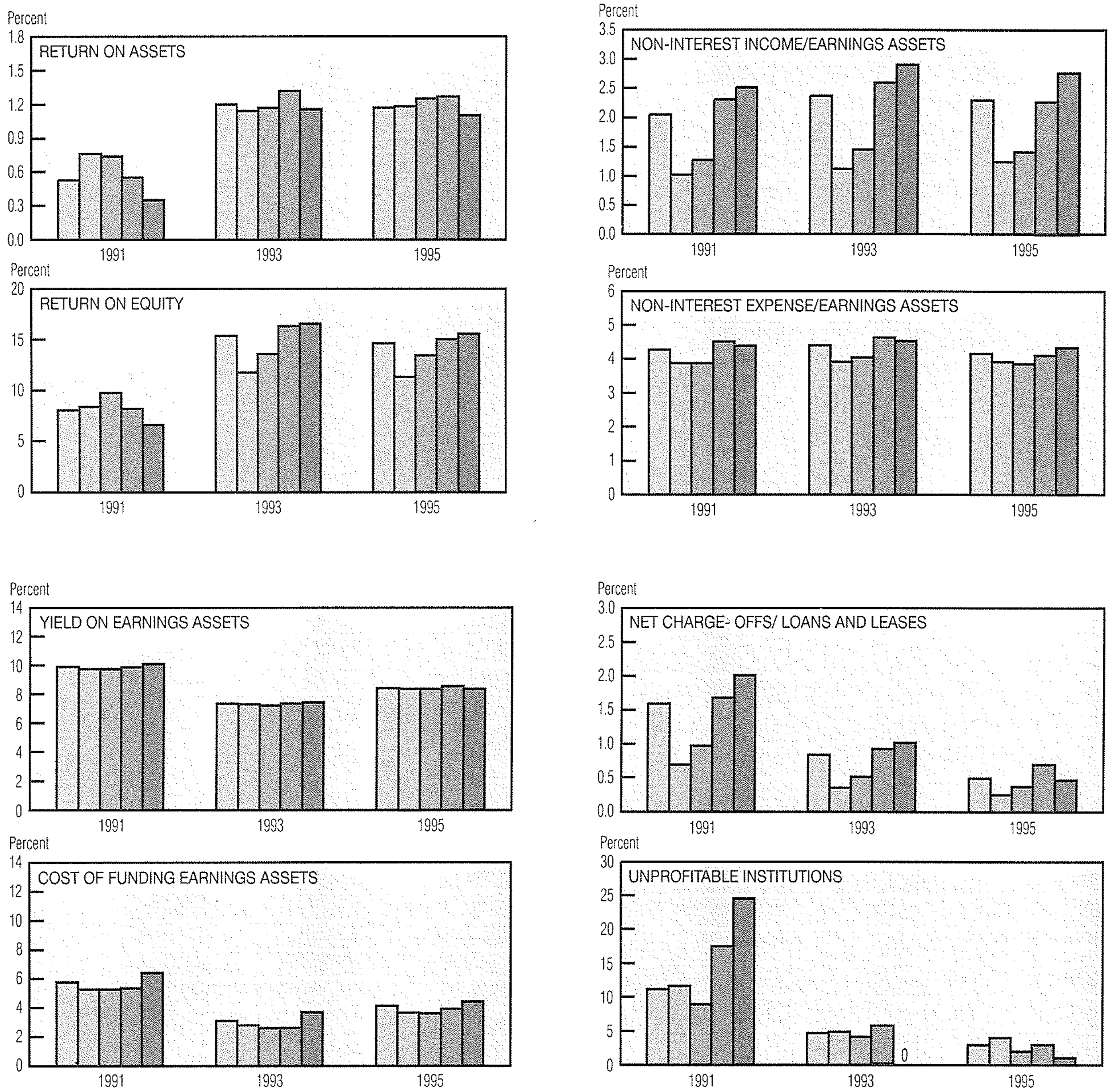
Banking Conditions (cont.)



All institutions · Less than $100 million in assets · $100 million to $1 billion in assets · $1 billion to $10 billion in assets · More than $10 billion in assets

SOURCE: Federal Deposit Insurance Corporation.

their share of the industry's deposits and assets.

Banking consolidation has affected the industry's performance because banks of different sizes have different ways of doing business. For instance, larger banks tend to have higher operating costs. They make more loans that turn out to be uncollectable, have higher funding costs, and incur greater non-interest expenses. However, their non-interest income is sufficiently high to overcome these costs. In addition, their easier access to capital markets allows them to operate with lower capital/asset ratios. This explains why they do better in terms of return on equity but not (in the case of the very largest banks) in terms of return on assets. These results seem to accord with recent research that fails to find economies of scale for the very largest banks.

As expected, the 1994 enactment of the Interstate Banking and Branching Efficiency Act began a new wave of bank mergers. However, the effects of this consolidation will differ from those driven by the regulatory changes of the 1980s. The 1994 act's most important change is that it permits BHCs to convert their banks, even if they are located in several states, into a single network of branches. This will most likely have a greater impact on larger banking organizations by giving them an opportunity to reduce their non-interest expenses, an area in which smaller banks have traditionally had more success.