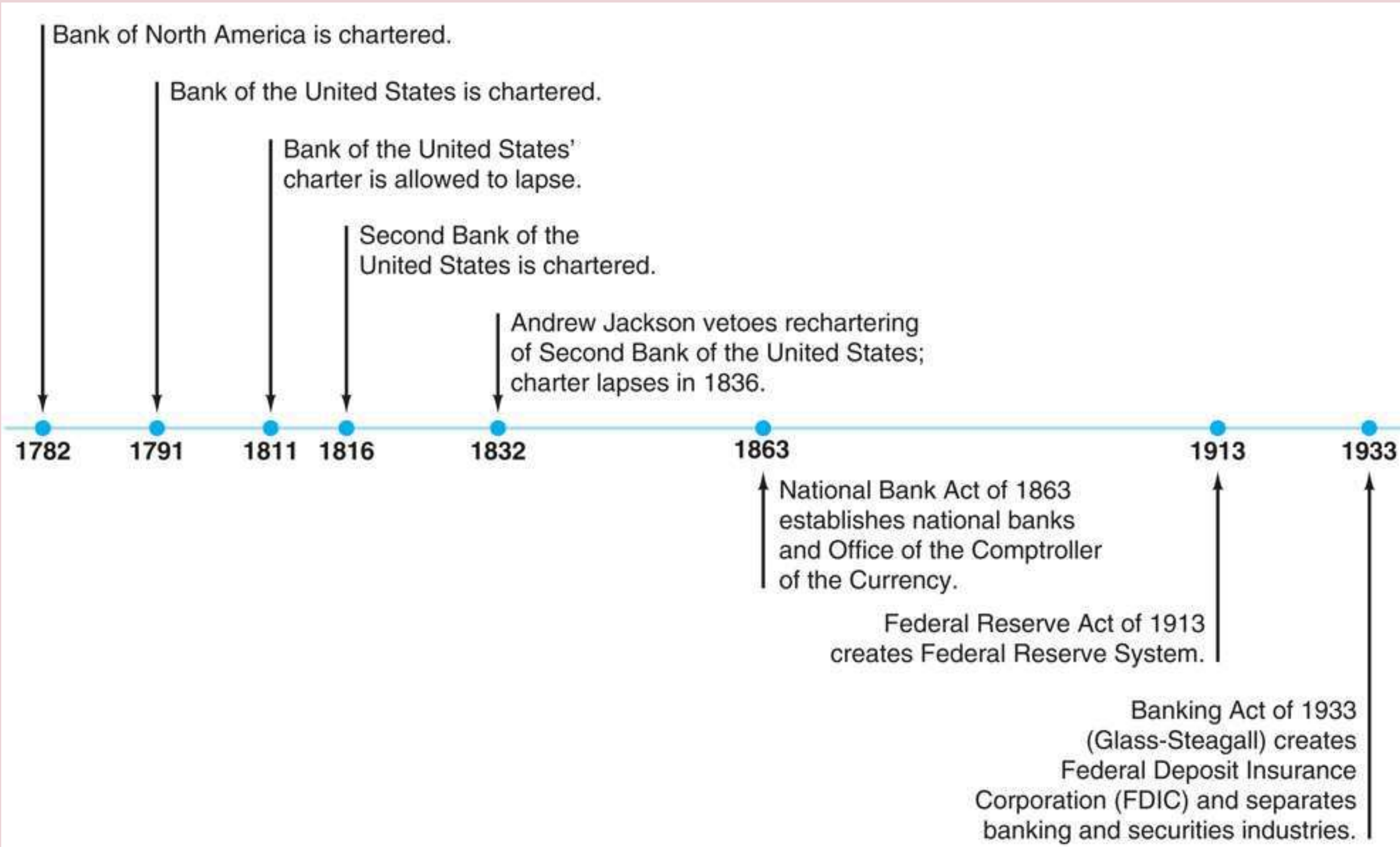
Historical Development of the Banking System

- Bank of North America chartered in 1782
- Controversy over the chartering of banks.
- National Bank Act of 1863 creates a new banking system of federally chartered banks
  - Office of the Comptroller of the Currency
  - Dual banking system
- Federal Reserve System is created in 1913.

Figure 1 Time Line of the Early History of Commercial Banking in the United States



Primary Supervisory Responsibility of Bank Regulatory Agencies

- Federal Reserve and state banking authorities: state banks that are members of the Federal Reserve System.
- Fed also regulates bank holding companies.
- FDIC: insured state banks that are not Fed members.
- State banking authorities: state banks without FDIC insurance.

Financial Innovation and the Growth of the “Shadow Banking System”

- Financial innovation is driven by the desire to earn profits
- A change in the financial environment will stimulate a search by financial institutions for innovations that are likely to be profitable
  - **Financial engineering**

Responses to Changes in Demand Conditions: Interest Rate Volatility

- Adjustable-rate mortgages
  - Flexible interest rates keep profits high when rates rise
  - Lower initial interest rates make them attractive to home buyers
- Financial Derivatives
  - Ability to hedge interest rate risk
  - Payoffs are linked to previously issued (i.e. derived from) securities.

Responses to Changes in Supply Conditions: Information Technology

- Bank credit and debit cards
  - Improved computer technology lowers transaction costs
- Electronic banking
  - ATM, home banking, ABM and virtual banking
- Junk bonds
- Commercial paper market

Responses to Changes in Supply Conditions: Information Technology (cont'd)

- Securitization
  - To transform otherwise illiquid financial assets into marketable capital market securities.
  - Securitization played an especially prominent role in the development of the subprime mortgage market in the mid 2000s.

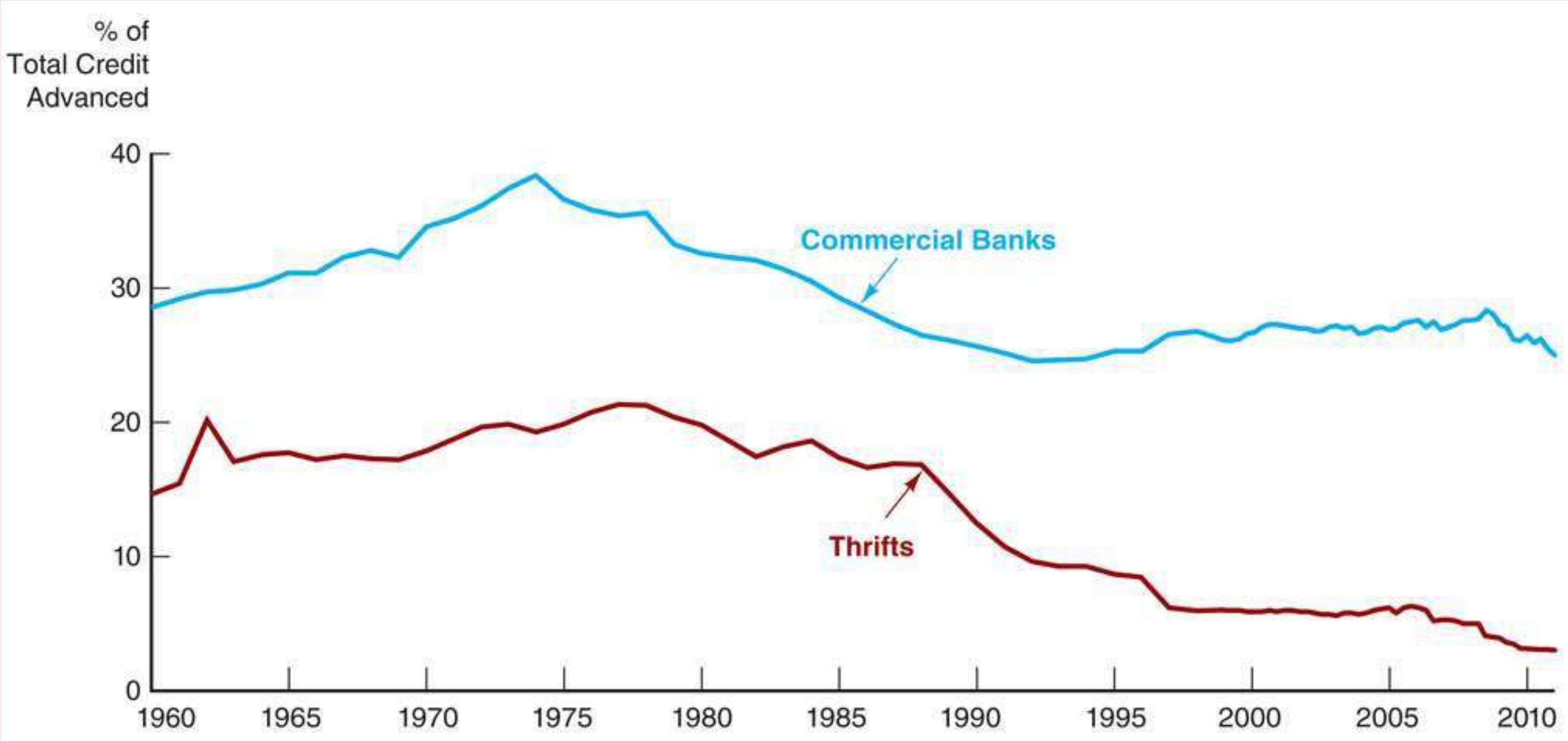
Avoidance of Existing Regulations: Loophole Mining

- Reserve requirements act as a tax on deposits
- Restrictions on interest paid on deposits led to disintermediation
- Money market mutual funds
- Sweep accounts

Financial Innovation and the Decline of Traditional Banking

- As a source of funds for borrowers, market share has fallen
- Commercial banks’ share of total financial intermediary assets has fallen
- No decline in overall profitability
- Increase in e from off-balance-sheet activities

Figure 2 Bank Share of Total Nonfinancial Borrowing, 1960–2011



Source: Federal Reserve Flow of Funds; . Flow of Funds Accounts; Federal Reserve Bulletin.

Financial Innovation and the Decline of Traditional Banking (cont'd)

- Decline in cost advantages in acquiring funds (liabilities)
- Rising inflation led to rise in interest rates and disintermediation
- Low-cost source of funds, checkable deposits, declined in importance

- Decline in e advantages on uses of funds (assets)
- Information technology has decreased need for banks to finance short-term credit needs or to issue loans
- Information technology has lowered transaction costs for other financial institutions, increasing competition

Banks' Responses

- Expand into new and riskier areas of lending
- Commercial real estate loans
- Corporate takeovers and leveraged buyouts
- Pursue off-balance-sheet activities
- Non-interest e
- Concerns about risk

Structure of the U.S. Commercial Banking Industry

- Restrictions on branching
  - McFadden Act and state branching regulations.
- Response to ranching restrictions
  - Bank holding companies.
  - Automated teller machines.

Table 1 Size Distribution of Insured Commercial Banks, March 30, 2011

Size Distribution of Insured Commercial Banks, March 30, 2011

Assets	Number of Banks	Share of Banks (%)	Share of Assets Held (%)
Less than $100 million	2,328	35.7	1.9
$100 million–$1 billion	3,693	56.6	11.5
$1 billion–$10 billion	423	6.5	12.8
More than $10 billion	86	1.3	73.9
Total	6,530	100.00	100.00

Source: www2.fdic.gov/qbp/2008sep/cb4.html.

Table 2 Ten Largest U.S. Banks, December 30, 2010

Ten Largest U.S. Banks, June 30, 2011

Bank	Assets ($ millions)	Share of All Commercial Bank Assets (%)
1. J.P. Morgan Chase	1,723,460	15.14
2. Bank of America Corp.	1,451,387	13.75
3. Citibank	1,161,359	10.20
4. Wells Fargo	1,093,030	9.60
5. U.S. Bank	305,969	2.69
6. PNC	251,221	2.21
7. Bank of NY Mellon	200,249	1.70
8. HSBC USA	197,545	1.69
9. FIA Card Service	188,639	1.66
10. TD Bank	175,145	1.54
Total	6,743,005	59.25

Source: www.federalreserve.gov/releases/h8/20081229.

Bank Consolidation and Nationwide Banking

- The number of banks has declined over the last 25 years
  - Bank failures and consolidation.
  - Deregulation: Riegle-Neal Interstate Banking and Branching Efficiency Act f 1994.
  - Economies of scale and scope from information technology.
- Results may be not only a smaller number of banks but a shift in assets to much larger banks.

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