Chapter 9

Bank balance sheet, a list of the bank’s assets and liabilities.

Sources of bank funds (liabilities and capital) and uses to which the funds are put (assets).

A bank acquires funds by issuing (selling) liabilities, which are the sources of funds the bank uses. The funds obtained from issuing liabilities are used to purchase income-earning assets.

Checkable deposits are bank accounts that allow the owner of the account to write check to third parties.

Checkable deposits are payable on demand

Nontrans action deposits are the primary source of bank funds; owners cannot write checks on nontrans action deposits, but the interest rates paid on these deposits are usually higher than those on checkable deposits.

Time deposits have a fixed maturity length, ranging from several months to over five years.

Borrowings from the Fed are called discount loans (advances); banks also borrow reserves overnight in the federal (fed) funds market from other U.S. banks and financial institution.

Bank Capital (net worth), equals the difference between total assets and liabilities. Bank capital is raises by selling new equity (stock) or from retained earnings. Bank’s capital is its cushion against a drop in the value of its assets, which could force the bank into insolvency, which occurs when a bank has liabilities in excess of assets, meaning that the bank can be forces into liquidation.

A bank uses the funds that it has acquired by issuing liabilities to purchases income-earning assets, naturally referred to as uses of funds and the interest payments eared on them are what enable banks to make profits.

All banks hold some of the funds they acquire as deposits in an account at the fed. Reserves consist of these deposits plus currency that is physically held by bank (called vault cash because it is stored in bank vaults overnight)

Some reserves, called required reserves, are held b/c of reserve requirtments, the regulation that for every dollar of checkable deposits at a bank, a certain fraction much be kept as reserves. The fraction is called required reserve ratio.

Banks hold additional reserves, called excess reserves, b/c they are the most liquid of all bank assets and a bank can use them to meet its obligations when fund are withdraw, either directly by a depositor or indirectly when check is written on an account.

These securities can be classified into three categories: U.S. government and agency securities, state and local government securities, and other securities. The U.S. government and agency securities are the most liquid b/c they can be easily traded and converted into cash with low transaction costs. B/c of their high liquidity, short-term U.S. government securities are called secondary reserves.

A loan is a liability for the individual or corporation receiving it but an asset for a bank, b/c it provides income to the bank. Loans are typically less liquid than other assets b/c they cannot be turned into cash until the loan maturities.

The major difference in the balance sheet of the various categories of depository institutions is primarily in the type of loan in which they specialize.

The physical capital (bank building, computers, and other equipment) owned by banks is included in the other assets category.  
asset transformation: Banks make profits by selling liabilities with one set of characteristics (a particular combination of liquidity, risk, size, and return) and using the proceeds to buy assets with a different set of characteristic. The process is often referred to as asset transformation.

T-account : is a simplified balance sheet, with lines in the form of a T, that lists only the changes that occurs in balance sheet items starting from some initial balance sheet position.

A increase in the bank’s reserves equal to the increase in checkable deposits.

When a bank receives additional deposits, it gains an equal amount of reserves; when it loses deposits, it loses an equal amount of reserves.

Deposit outflow : that is, when deposits are lost b/c depositors make withdraws and demand payment. To keep enough cash on hand, the bank must engage in liquidity management, the acquisition of assets that are liquid enough to meet the bank’s obligations to depositors.

Banks manager must pursue an acceptably low level of risk by acquiring assets that have a low rate of default and by diversifying asset holding (asset management).

Liability management : concern is acquiring funds at low cost.

Capital adequacy management: decide the amount of capital the bank should maintain and then acquire the needed capital.

Credit risk: the risk arising b/c borrowers may default, and how it manage interest-rate risk, the riskiness of earning and returns on bank assets caused by interest-rate changes.

If a bank has ample excess reserves, a deposit outflow does not necessitate change in other parts of its balance sheet.

A second method of reducing its loan is for the bank of sell them off to other bank.

The foregoing discussion explains why banks hold excess reserves even though loans or securities earn a higher return when deposit outflow occurs, excess reserves enable the bank to escape the costs of (1) borrowing from other banks or corporations, (2) selling securities (3) borrowing from the fed, or (4) calling in or selling off loans.

Excess reserves are insurance against the costs associated with deposit outflows. The higher the cost associated with deposit outflows, the more excess reserves a bank will want to hold.

To maximize its profits, a bank must simultaneously seek the highest returns possible on loans and securities, reduce risk, and make adequate provisions for liquidity by holding liquid assets.

First bank try to find borrowers who will pay high interest rates and are unlikely to default on their loans; second banks try to purchase securities with high returns and low risk; third, in managing their assets, banks must attempt to lower risk by diversifying; Finally, the bank must manage the liquidity of its asset so that it can meet deposit outflows and still satisfy its reserve requirements without bearing huge costs.

Two main reasons for emphasis on asset management. First, more than 60% of bank funds were obtained through checkable (demand) deposits that by law could not pay any interest. Second, b/c the markets for making overnight loans between banks were not well develop, banks rarely borrowed from other banks to meet their reserve needs