UNIVERSITY OF THE PEOPLE

BUS 2203-01 Principles of Finance 1 – AY2024-T2

Learning Journal Unit 4

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Chapter 9 covers bank management principles and risks. A bank's balance sheet shows what it owns (assets) and owes (liabilities), with the difference being shareholder equity or capital. Major assets include reserves, secondary reserves like bonds, loans, and physical assets. Major liabilities include different types of deposits and borrowings.

Bank managers must balance competing needs to manage liquidity (having adequate reserves), asset quality (making profitable but not too risky loans), liabilities (funding assets in a low-cost way), and capital adequacy (having enough equity cushion against losses). Too many reserves or too much capital reduces bank profitability, but too little exposes banks to liquidity crises or even failure.

Banks face credit risk, or borrowers defaulting on loans, and interest rate risk from rates rising and falling. To manage credit risk, bankers screen applicants, monitor loans, require collateral, limit loan amounts, and specialize in particular types of lending. Long-term customer relationships also aid credit risk management. “No matter how good bankers are at asset, liability, and capital adequacy management, they will be failures if they cannot manage credit risk” (Wright & Quadrini, 2009). Interest rate risk matters because when rates rise, bank funding costs may increase faster than asset yields, squeezing profits. Bankers use gap analysis to quantify rate sensitivity and strategies like keeping deposit durations short when rates seem likely to fall.

Banks also engage in off-balance sheet activities like charging fees, selling loans, and derivatives trading to earn profits not reliant on interest rates. These activities help manage risks but also can expose banks to new risks, like loan buyers defaulting or derivatives bets going sour. Rogue traders have caused massive losses in some cases. But techniques like value-at-risk models can help bankers measure how much derivatives activities endanger their institutions.

Reference:
Wright, R.E. & Quadrini, V. (2009). Money and Banking. Saylor Foundation.

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