UNIVERSITY OF THE PEOPLE

BUS 2203-01 PRINCIPLES OF FINANCE 1 - AY2024-T2

WRITTEN ASSIGNMENT UNIT 4

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The most salient distinction between corporate and bank balance sheets lies in their composition of assets and liabilities. Whereas a typical company's assets encompass tangible holdings like inventory and property alongside intangibles like intellectual property, a bank's assets majorly comprise financial claims including loans, securities, and cash reserves. “A balance sheet is a financial statement that lists what a company owns (its assets or uses of funds) and what it owes (its liabilities or sources of funds)” (Wright & Quadrini, 2009).

1. A bank balance sheet is different from that of a typical company. Explain the differences.

A bank's balance sheet differs from a typical company in a few keyways. First, banks have very high levels of liabilities versus equity capital because of their business model of borrowing money via deposits and debt to fund lending and investments. Second, banks hold specialized assets like loans and securities tailored to their liquidity needs and interest rate risk preferences. Third, banks operate in a highly regulated environment where capital levels are mandated.

2. Looking at the percentages, comment on the Assets and Liabilities of the above Balance sheet. Why do bank managers prefer Loans over Securities? Why is cash only 4%?

The structure of XY Bank's balance sheet reveals some key aspects of its business. First, liabilities and equity capital are listed directly below assets, unlike a typical company that would show liabilities on the right side. This is standard for bank balance sheets. Second, loans comprise a sizable 64% of assets, while securities are only 20%. As banks generate higher returns from loans versus securities, XY Bank, like most banks, emphasizes its lending activity to maximize profits. Third, cash reserves constitute just 4% of assets. Banks aim to minimize cash that earns no interest. XY Bank likely retains enough cash to meet client withdrawal needs, but does not keep reserves equal to total deposits, as routinely lending out deposits is central to the banking model. The dominance of loans and lack of liquidity reflect strategic choices to boost XY Bank's bottom line over simply holding low-yielding assets or cash.

3. Describe the difference for at least three of the balance sheet elements.

Some specific differences include:

Assets

- Banks hold cash "reserve" assets to pay deposit withdrawals, which companies don't require. Regulators specify minimum reserve levels.
- Securities held are often short-term bonds used as "secondary" backup to reserves, while companies usually invest surplus cash in equities or long-term value assets.
- Loans usually dominate bank balance sheets as the biggest revenue generator. In contrast, companies have high tangible capital like property, plants, and equipment.

Liabilities

- Bank liabilities are predominantly customer deposits, a unique funding source representing money owed to the public, while companies rely more on equity, bonds, and loans.
- Deposits range from on-demand checkable deposits to time certificates with set maturities, tailored to meet banks' liquidity needs.

Equity

- Stringent capital adequacy regulation mandates that banks have equity levels as a percent of risk-weighted assets, to act as a buffer protecting depositors, which companies don't face.

4. Discuss at least 2 of why bank managers prefer loans over securities.

    a. Bank managers prefer issuing loans versus buying securities because loans offer higher potential returns. Additionally, establishing lending relationships helps banks cross-sell fee-based services and access low-cost core deposits.

    b. Loans also allow for credit risk management through close borrower monitoring that isn't possible in securities.

5. Use at least one example in the essay.

For example, a bank might offer a below-market $5 million construction loan at 5% to win a new commercial customer. Through the relationship, it can then harvest that company's employees' personal checking accounts with small balances earning little interest cost to the bank but providing lucrative ancillary fee income like debit card swipe fees. The bank can also monitor the project closely via lien covenants and onsite visits that help manage credit exposures.

References:

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

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