Banks

Chapter 2

Nature of Banking

- Commercial banking
  - Taking deposits, making loans (wholesale or retail)
  - Money center banks operate in the wholesale market and often fund loans by borrowing
- Investment banking
  - Raising debt and equity for companies; advice on mergers and acquisitions, restructurings, trading, etc

Structure of Banking in the US

- Large international banks (small number)
- Regional banks (several hundred)
- Small community banks (several thousand)

History of Bank Regulation in US
(page 26-28)

- McFadden Act (1927, 1933)
- Douglas Amendment (1956)
- Bank Holding Companies Act (1970)
- Riegel-Neal Interstate Banking and Branching Efficiency Act (1994)

Example of Simple Bank Balance Sheet: End 2023

Assets		**Liabilities**	
Cash	5	Deposits	90
Marketable Securities	10	Subord L.T. Debt	5
Loans	80	Equity Capital	5
Fixed Assets	5		
Total	100	Total	100

Income Statement: 2023

Net Interest Income	3.00
Provision for Loan Losses	(0.80)
Non-Interest Income	0.90
Non-Interest Expense	(2.50)
Pre-Tax Operating Income	0.60

Year 2024

- What happens in year 2024 if it is the same as year 2023 except that provision for loan losses is 4.0 instead of 0.8?

What if Balance Sheet Had Been More Aggressive?

Assets		Liabilities	
Cash	5	Deposits	94
Marketable Securities	10	Subord L.T. Debt	5
Loans	80	Equity Capital	1
Fixed Assets	5		
Total	100	Total	100

Regulation

- Regulators set minimum levels for the capital a bank is required to keep
- Equity is an example of Tier 1 capital
- Subordinated long term debt is an example of Tier 2 capital

Deposit Insurance (pages 30-31)

- Most countries have deposit insurance programs that insure depositors against losses up to a certain level
- In the US the FDIC has provided protection for depositors since 1933
- The amount insured was $2,500 in 1933
- It has been increased several times
- Following the credit crisis it was increased from $100,000 to $250,000 in October 2008.
- Why might deposit insurance encourage a bank to take risks?

Investment Banking

- Methods of raising debt or equity
  - Public offering
  - Private placement
  - Best efforts
  - Firm commitment

Best Efforts vs Firm Commitment
(page 32)

- 50 million shares are to be issued and target price is $30 per share
- Best efforts would lead to a fee of 30 cents per share; firm commitment leads to bank buying the shares at $30 per share

	Best efforts	Firm Commitment
Can sell at $29	+$15 million	−$50 million
Can sell at $32	+$15 million	+$100 million

Initial Public Offering (IPO)

- Usually on a best efforts basis
- Bank will set offering price sufficiently low that shares are almost certain to be sold
- Often price rises immediately after IPO
- Banks often offer shares only to fund managers and their best customers

Dutch Auction IPO

- Individuals and companies bid by indicating the number of shares they want and the price they are prepared to pay
- The price paid is the lowest bid that leads to all the shares being sold

Example: How are 1 million shares allocated in this situation?

Bidder	Number of Shares	Price
A	100,000	$30.00
B	200,000	$28.00
C	50,000	$33.00
D	300,000	$29.00
E	150,000	$30.50
F	300,000	$31.50
G	400,000	$25.00
H	200,000	$30.25

Google's IPO in 2004 (Business Snapshot 2.1)

- A Dutch Auction where Google retained the right to change the number of shares that would be issued and the percentage allocated to each bidder
- Investors who bid $85 or more obtained 74.2% of the shares they had bid for

Securities Trading

- Exchange-traded vs OTC
- Why do banks trade?
- Brokerage services
  - Full service
  - Discount
  - On line

Potential Conflicts of Interest

- Bank recommends securities investment bank is trying to sell
- Commercial bank passes confidential information on a client to investment bank
- Stock recommended as a “buy” to please company’s management in order to get investment banking business
- Investment bank sell securities for a company so that commercial bank can get rid of a loan

Accounting (page 40)

- Banking book vs trading book
- Under a new accounting rule (IFRS 9 and an FASB update) lenders have to estimate expected credit losses and subtract them from the amount owed on loans

The Originate-to-Distribute Model

- Very popular way of handling mortgages during the 2000 to 2007 period
- Banks originated loans and then packaged them into products that were sold to investors
- This frees up funds to make more loans