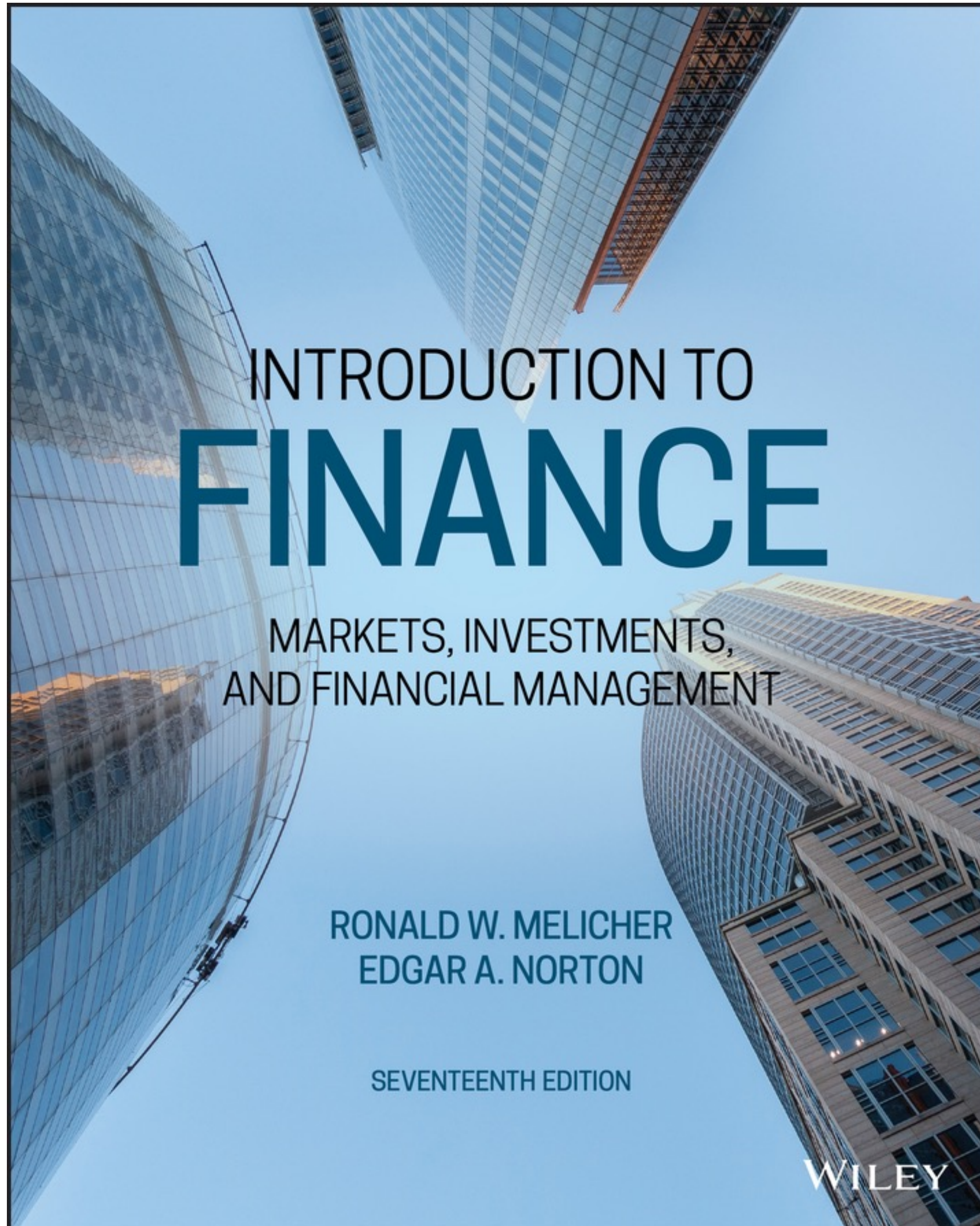
Chapter 3

Banks and Other Financial Institutions



Learning Objectives

- LO 3.1 Describe how financial institutions were impacted by the financial crisis.
- LO 3.2 Identify the major financial institutions and their roles in the financial system.
- LO 3.3 Describe how commercial banking and investment banking differ, and identify the functions of banks and the banking system.

Learning Objectives

- LO 3.4 Discuss the historical development of the U.S. banking system.
- LO 3.5 Discuss general regulation of the banking system and how depositors' funds are protected.
- LO 3.6 Describe the structure of banks in terms of bank charters, branch banking, and bank holding companies.

Learning Objectives

- LO 3.7 Describe the bank balance sheet and the major account categories that it contains.
- LO 3.8 Describe bank management practices in terms of bank liquidity and bank solvency, and explain why and how bank capital is managed.
- LO 3.9 Describe characteristics of several foreign banking systems.

Section 3.1: Financial Institution Problems During the 2007-2008 Financial Crisis

- LO 3.1 Describe how financial institutions were impacted by the financial crisis.

Financial Institution Distress

- Homeowners use mortgage loans to finance a portion of their houses
- Mortgage-backed securities are created by pooling together a package of mortgage loans
- After the housing price bubble burst in mid-2006, mortgage loan defaults increased and the value of mortgage-related securities decreased

Financial Institution Distress

- Many banks and other financial institutions did not have adequate equity capital to cover the loss in value of mortgage-related securities
- As a result, the Federal Reserve and the U.S. Treasury in 2008 helped weaker institutions sell to, or merge with, relatively-stronger institutions

Section 3.2: Types and Roles of Financial Institutions

- LO 3.2 Identify the major financial institutions and their roles in the financial system.

Types and Roles

- Financial Intermediation

  Process by which savings are accumulated in depository institutions and then lent or invested

- Financial Institutions Categories

  Depository Institutions

  Contractual Savings Organizations

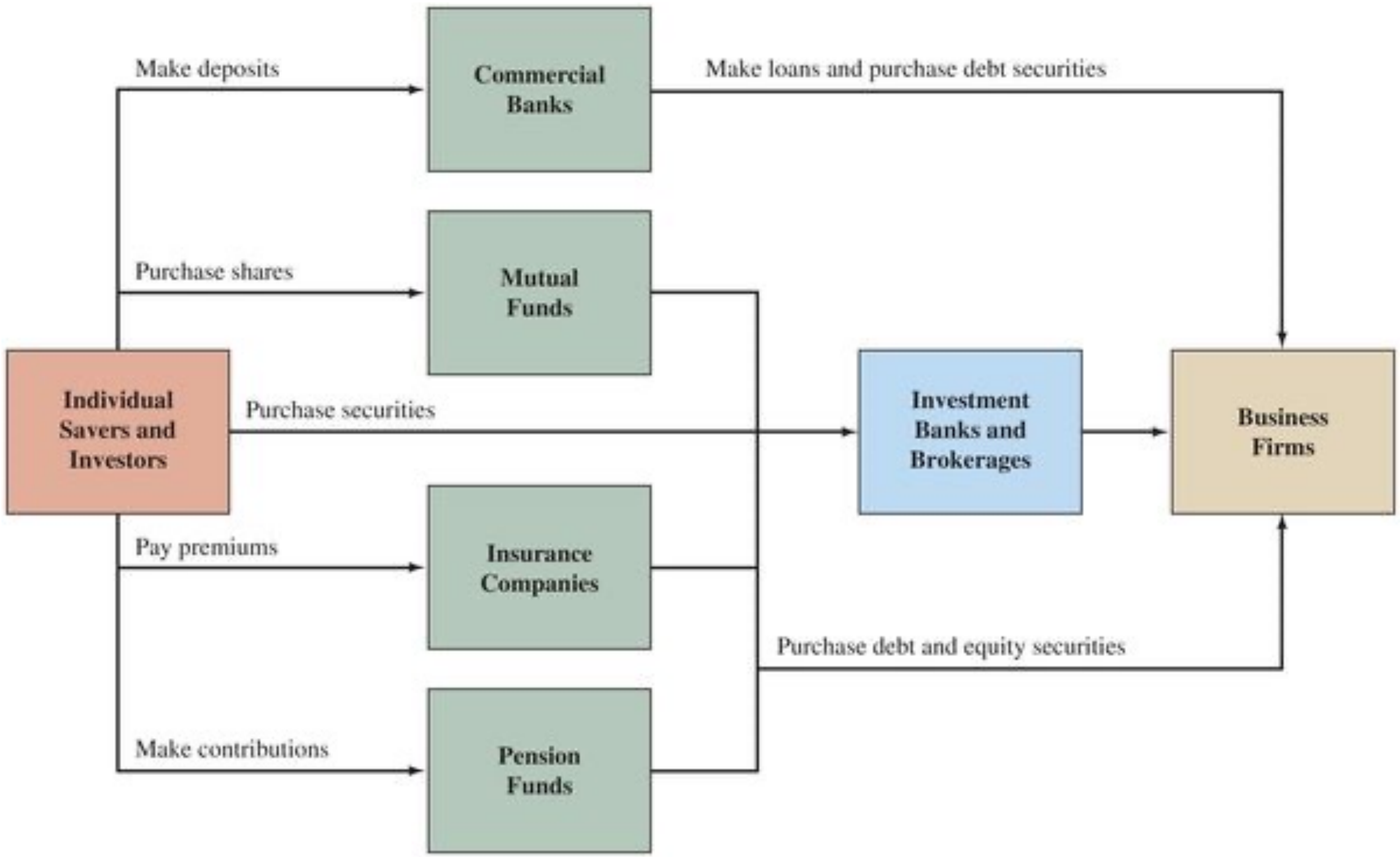
  Securities Firms

  Finance Firms

Types and Roles

- Figure 3.1 in text shows the types of major financial institutions as well as each institution's primary source of funds
- Figure 3.2 in text depicts the process of directing savings and investments of individuals through financial institutions to business firms

Figure 3.1 Types of Financial Institutions



Depository Institutions

- Accept deposits from individuals and then lend pooled deposits to businesses, governments, and individuals
- Four Types
  – Commercial Banks
  – Savings and Loan Associations
  – Savings Banks
  – Credit Unions

Depository Institutions

- Commercial Banks

  Depository institutions that accept deposits, issue check-writing accounts, and make loans

- Thrift Institutions

  Noncommercial bank depository institutions that accumulate individual savings and primarily make consumer and mortgage loans

Depository (Thrift) Institutions

- Savings Banks

  Accept the savings of individuals & lend pooled savings to individuals mainly in the form of mortgage loans
- Savings and Loan Associations

  Accept individual savings and lend pooled savings to individuals (primarily in the form of mortgage loans) and businesses
- Credit Unions

  Cooperative nonprofit organizations that exist primarily to provide member depositors with consumer credit

Contractual Savings Organizations

- Organizations collect premiums and contributions from participants and provide insurance against major financial losses and retirement
- Two Types
  - Insurance Companies
  - Pension Funds

Contractual Savings Organizations

- Insurance Companies

  Provide financial protection to individuals and businesses for life, property, liability, and health uncertainties
- Pension Funds

  Receive contributions from employees and/or their employers and invest the proceeds on behalf of the employees for use during their retirement years

Securities Firms

- Accept and invest individual savings and also facilitate the sale and transfer of securities between investors
- Three Types
  - Investment Companies (Mutual Funds)
  - Investment Banking Firms
  - Brokerage Firms

Securities Firms

- Investment Companies

  Sell shares in their firms to individuals and others and invest the pooled proceeds in corporate and government securities
- Mutual Funds

  Open-end investment companies that can issue an unlimited number of their shares to their investors & use the pooled proceeds to purchase corporate and government securities

Securities Firms

- Investment Banking firms
  Sell or market new securities issued by businesses to individual and institutional investors
- Brokerage Firms
  Assist individuals to purchase new or existing securities issues or to sell previously purchased securities

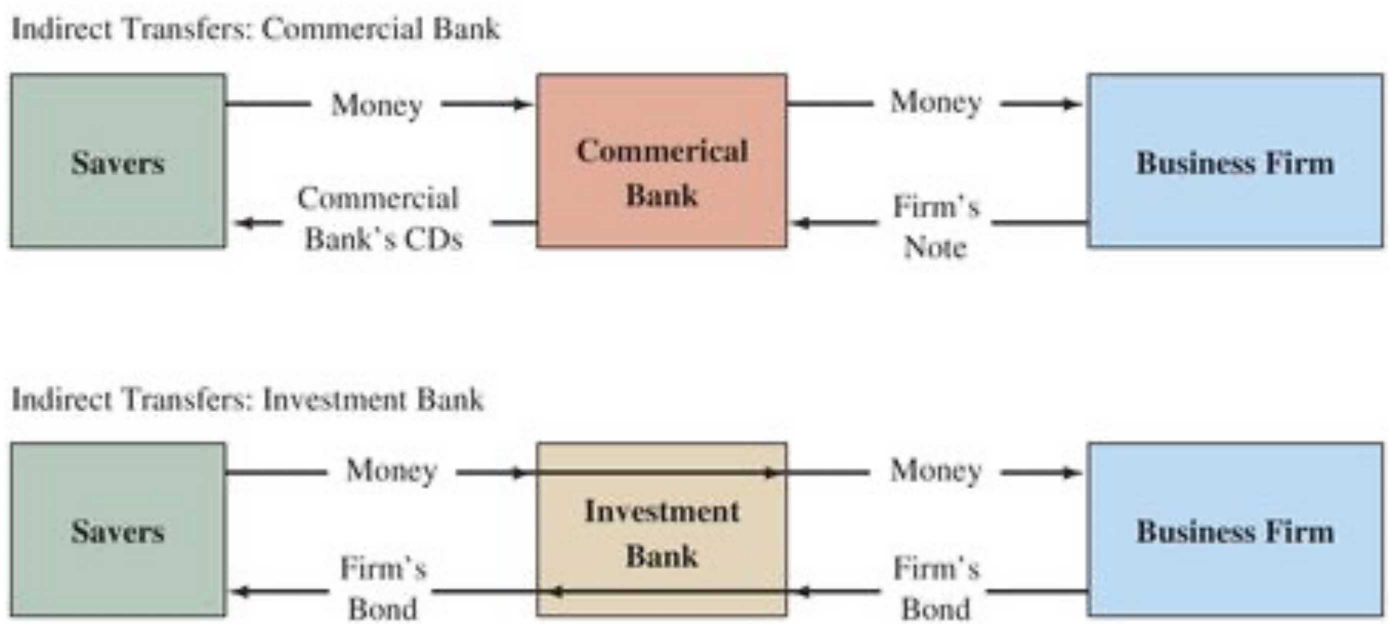
Finance Firms

- Provide loans directly to consumers and businesses and help borrowers obtain mortgage loans on real property
- Two Types
  - Finance Companies
  - Mortgage Banking Firms

Finance Firms

- Finance Companies
  Provide loans directly to consumers and businesses or aid individuals in obtaining financing of durable goods and homes
- Mortgage Banking Firms
  Originate mortgage loans on homes and other real property by bringing together borrowers and institutional investors

Figure 3.2 Role of Financial Institutions in Directing Savings to Business Firms



Section 3.3: Overview of the Banking System

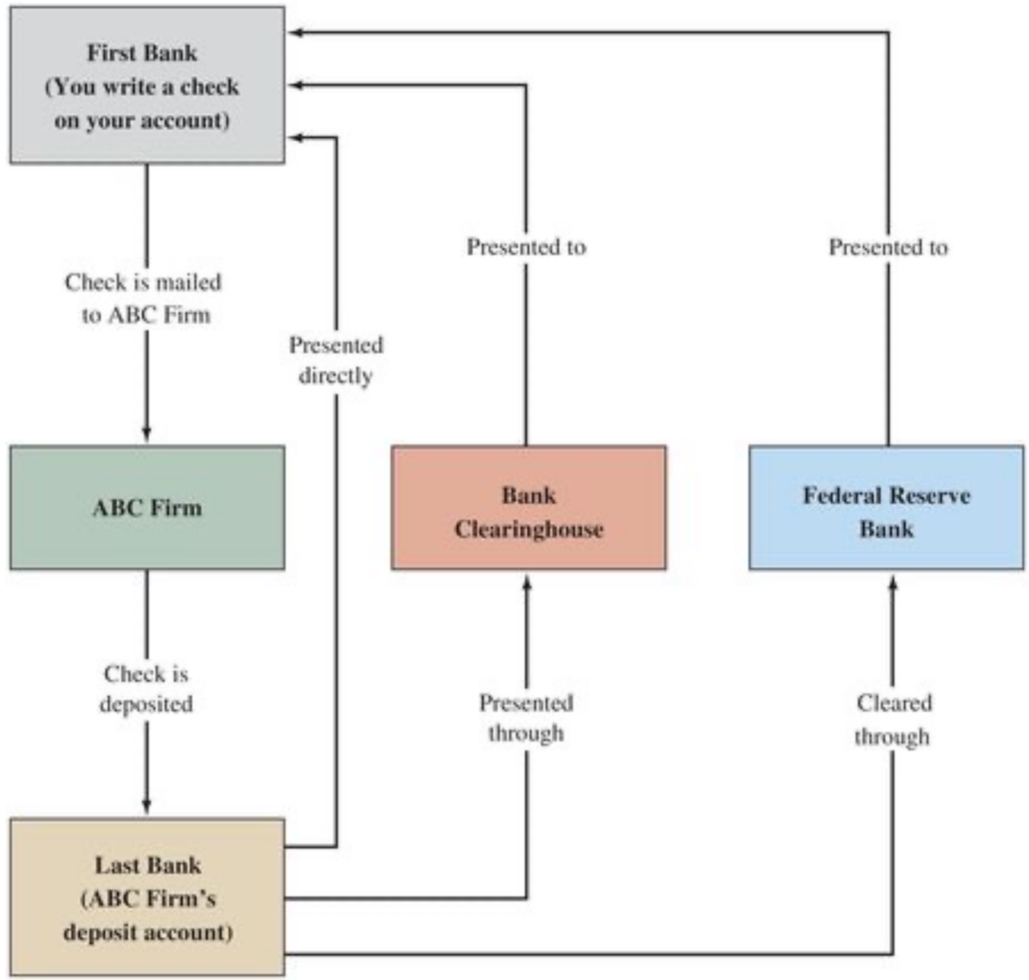
- LO 3.3 Describe how commercial banking and investment banking differ, and identify the functions of banks and the banking system.

Banking System

- Commercial Bank
  Accepts deposits, makes loans, and issues check-writing accounts
- Investment Bank
  Helps businesses sell their securities to raise financial capital
- Universal Bank

  Bank that engages in both commercial banking and investment banking activities

Figure 3.3 Commercial Banking and Investment Banking Intermediation Activities



Commercial Banking Intermediation Activities

1. *Savers* deposit money in a *Commercial Bank* and receive, in return, Certificates of Deposit (or have savings accounts set up for them)
2. The *Commercial Bank* lends money to a *Business Firm* and receives, in return, the firm's note which is a promise to repay the loan

Investment Banking Intermediation Activities

1. *Savers* provide money to an *Investment Bank* and receive, in return, the securities (e.g., bonds) issued by a *Business Firm*
2. The *Investment Bank* either first purchases the *Business Firm's* securities (e.g., bonds) and resells them to *Savers*, or just "markets" the securities to *Savers*

Legislation Involving Both Commercial and Investment Banking

- Glass-Steagall Act of 1933: Provided for separation of commercial banking and investment banking activities in the U.S.
- Gramm-Leach-Bliley Act of 1999: Repealed the separation of commercial banking and investment banking activities provided for in the Glass-Steagall Act

Functions of Banks and the Banking System

Five Functions:

1. Accepting deposits
2. Granting loans
3. Issuing checkable deposit accounts
4. Clearing checks
5. Creating deposit money

Some Banks Perform a Sixth Function:

6. Raising financial capital for businesses (if involved in investment banking)

Traditional Methods for Processing or Clearing Checks Through the Banking System

A "check" can be:

- Presented directly to the bank on which it was written
- Presented through a bank clearinghouse and then to the bank on which it was written
- Cleared through a Federal Reserve Bank and then presented to the bank on which it was written

Section 3.4: Historical Development of the U.S. Banking System

- LO 3.4 Discuss the historical development of the U.S. banking system.

Early Historical Developments

Before the Civil War

- Early Chartered Banks
- First Bank of the United States
- Second Bank of the United States
- State Banks from 1836 to the Civil War

Entry of Thrift Institutions

Section 3.5: Regulation of the Banking System

- LO 3.5 Discuss general regulation of the banking system and how depositors' funds are protected.

General Banking Legislation

Laws Regulating the Banking System

- National Banking Act of 1864
- Federal Reserve Act of 1913
- Banking Act of 1933 (Glass-Steagall Act)
- Depository Institutions Deregulation and Monetary Control Act of 1980

General Banking Legislation

Laws Regulating the Banking System

- Garn-St. Germain Depository Institutions Act of 1982
- Gramm-Leach-Bliley Act of 1999
- Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

DODD-FRANK ACT OF 2010

- The Act was designed to promote financial stability by improving accountability and transparency in the financial system
- Making the Act comprehensive resulted in a 2300-page document that became very difficult to implement
- Of concern was the possibility of *financial systemic risk* where a few banks could lead to the collapse of an entire system

Savings and Loan 1980s-1990s Crisis

- **What happened?**

  Mid-1980s to Mid-1990s: Over 2,000 savings and loan associations (S&Ls) were closed or merged into other institutions

- **Why did it happen?**

  S&Ls failed due to:

  1. mismanagement
  2. greed that led to fraudulent activities on the part of some officers and managers

Nature of S&L Business Activities

- S&Ls borrow short-term by accepting the deposits of savers and paying interest on the savings
- S&Ls, in turn, provide long-term mortgage loans to help finance homes
- The result is loan illiquidity and financing cost risk associated with rising short-term interest rates

Changing S&L Business Activities

- Deregulation caused additional S&L operating difficulties
- In early 1980s, S&Ls were permitted to invest in a range of high-yielding investments including speculative office/commercial buildings and “junk” (low quality) bonds issued by businesses
- S&L managements were ill prepared for deregulation resulting in mismanagement
- Greed also resulted in fraudulent behavior on the part of some officers and managers

Protection of Depositors' Funds

- The Federal Deposit Insurance Corporation (FDIC) was created in 1933 to protect deposits in banks
- The Federal Savings and Loan Insurance Corporation (FSLIC) was created to protect deposits in S&Ls [replaced by SAIF in 1989]
- The National Credit Union Share Insurance Fund (NCUSIF) was created to protect deposits in credit unions

Protection of Depositors' Funds

- Deposit account insurance has been increased over time--it reached $100,000 in 1980 and currently is $250,000
- Bank Insurance Fund: Collects annual insurance premiums from commercial banks to create the pool of funds available to FDIC for covering insured depositors
- Federal Deposit Insurance Corporation Improvement Act of 1991: Provides for differences in deposit premiums based on the relative riskiness of banks

Section 3.6: Structure of Banks

- LO 3.6 Describe the structure of banks in terms of bank charters, branch banking, and bank holding companies.

Bank Charters

- Dual Banking System
  Commercial banks can obtain charters either from the federal government or a state government
- Federally Chartered Banks
  Must have "national" in their titles and be members of the Federal Reserve System and the Federal Deposit Insurance Corporation

Branch Banking

- Unit Banking

  Exists when a bank can have only one full-service office

- Limited Branch Banking

  Allows additional banking offices within a defined distance of a bank's main office

- Statewide Branch Banking

  Allows banks to operate offices throughout a state

Bank Holding Companies

- Holding Company
  A firm that owns and controls other organizations or firms
- One Bank Holding Company
  Permits a firm (OBHC) to own and control only one bank
- Multibank Holding Company
  Permits a firm (MBHC) to own and control two or more banks

Bank Holding Company Act of 1956

- The Act defined bank holding companies, established control over MBHC expansions, and required divestment of MBHC existing non-banking activities
- The *Banking Holding Company Amendments of 1970* brought the OBHCs under the provisions of the 1956 Act
- The 1970 amendments allowed bank holding companies to acquire companies with activities closely related to banking, such as credit card operations, insurance, and data processing services

Section 3.7: The Bank Balance Sheet

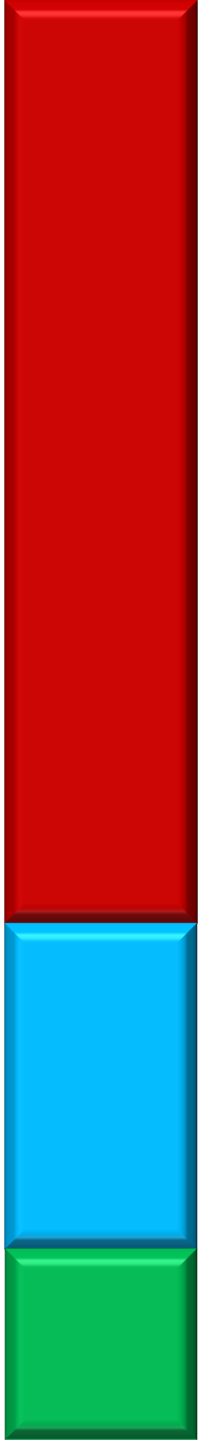
- LO 3.7 Describe the bank balance sheet and the major account categories that it contains.

Representative Distribution of Bank Assets

- Cash and Balances Due from Depository Institutions (about 7% of total assets)
- Securities (about 18% of total assets)
- Loans (about 59% of total assets)
- Other Assets (about 16% of total assets)

Types of Bank Loans

- Loans Secured by Real Estate
- Loans to Depository Institutions
- Commercial and Industrial Loans
- Loans to Individuals
- Other Loans



Representative Distribution of Bank Liabilities and Stockholders’ Equity

- Deposits (about 68% of total)
- Other Liabilities (about 24% of total)
- Stockholders’ Equity (about 8% of total)

Types of Bank Deposits

- Transaction Accounts

  Demand Deposits

  NOW Accounts

- Nontransactional Accounts

  Time Deposits

  Savings Deposits

- Foreign Deposits

Section 3.8: Bank Management

- LO 3.8 Describe bank management practices in terms of bank liquidity and bank solvency, and explain why and how bank capital is managed.

Basic Concepts

- Bank Liquidity
  Reflects ability to meet depositor withdrawals and to pay off other liabilities when due
- Bank Solvency
  Reflects ability to keep the value of a bank's assets greater than its liabilities

Liquidity Management

- Asset Management
  Maintaining "primary reserves" and "secondary reserves" to help meet depositor withdrawal demands and other liabilities when due
- Liability Management
  Adjusting interest rates on rate sensitive liabilities like CDs to help maintain a desired level of liquidity

Capital Management: Three Ratios

- Common Equity Capital Ratio

  (Common Equity/Total Assets) x 100

- Tier 1 Ratio

  (Common Equity + Noncumulative preferred stock + Trust-Preferred Securities – Intangible Assets)/Risk-Adjusted Assets

  Where: asset accounts are risk-weighted from low risk (0.00) for cash & government securities to high risk (1.00) for ordinary loans to arrive at total risk-adjusted assets

Capital Management: Three Ratios

- Total Capital Ratio:

  (Tier 1 Capital + Tier 2 Capital)/Risk-Adjusted Assets

  Where: Tier 2 Capital equals a bank's loan-loss reserve amount + other qualifying securities (e.g., subordinated debt and perpetual preferred stock) + net unrealized gains on marketable securities

Capital Management Ratio Examples

- Basic Information: a bank has total assets = \$100 million; risk-adjusted assets = \$80 million; common equity = \$4.5 million; trust-preferred securities = \$0.5 million; loan loss reserve = \$1 million; and subordinated debt = \$1.5 million
- Common Equity Capital Ratio = (\$4.5 million)/ \$100 million = 4.5%

Capital Management Ratio Examples

- Tier 1 Ratio
  = ($4.5 million + $0.5 million)/$80 million = $5 million/$80 million = 6.3%
- Total Capital Ratio
  = ($5 million + $1 million + $1.5 million)/$80 million = $7.5 million/$80 million = 9.4%

Section 3.9: International Banking and Foreign Systems

- LO 3.9 Describe characteristics of several foreign banking systems.

Basic Concepts and Terms

- International Banking

  Exists when banks operate in more than one country

- International Banking Act of 1978

  Provided more consistent regulation of banks across countries

- Banking Developments

  Germany and the United States are examples of universal banking countries

Web Links

- www.citibank.com
- www.chase.com
- www.stlouisfed.org
- www.federalreserve.gov
- www.sba.gov