

CHAPTER 1

AN OVERVIEW OF BANKS AND THE FINANCIAL-SERVICES SECTOR

Goal of This Chapter: In this chapter you will learn about the many roles financial service providers play in the economy today. You will examine how and why the banking industry and the financial services marketplace as a whole is rapidly changing, becoming new and different as we move forward into the future. You will also learn about new and old services offered to the public.

Key Topics in This Chapter

- Powerful Forces Reshaping the Industry
- What is a Bank?
- The Financial System and Competing Financial-Service Institutions
- Old and New Services Offered to the Public
- Key Trends Affecting All Financial-Service Firms
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Concept Checks

1-1. What is a bank? How does a bank differ from most other financial-service providers?

A bank should be defined by what it does; in this case, banks are generally those financial institutions offering the widest range of financial services. Other financial service providers offer some of the financial services offered by a bank, but not all of them within one institution.

1-2. Under U.S. law what must a corporation do to qualify and be regulated as a commercial bank?

Under U.S. law, commercial banks must offer two essential services to qualify as banks for purposes of regulation and taxation, demand (checkable) deposits and commercial loans. More recently, Congress defined a bank as any institution that could qualify for deposit insurance administered by the FDIC.

1-3. Why are some banks reaching out to become one-stop financial service conglomerates? Is this a good idea in your opinion?

There are two reasons that banks are increasingly becoming one-stop financial service conglomerates. The first reason is the increased competition from other types of financial institutions and the erosion of banks' traditional service areas. The second reason is the Financial Services Modernization Act which has allowed banks to expand their role to be full service providers.

1-4. Which businesses are banking's closest and toughest competitors? What services do they offer that compete directly with banks' services?

Among a bank's closest competitors are savings associations, credit unions, money market funds, mutual funds, hedge funds, security brokers and dealers, investment banks, finance companies, financial holding companies, and life and property-casualty insurance companies. All of these financial service providers are converging and embracing each other's innovations. The Financial Services Modernization Act has allowed many of these financial service providers to offer the public one-stop shopping for financial services.

1-5. What is happening to banking's share of the financial marketplace and why? What kind of banking and financial system do you foresee for the future if present trends continue?

The Financial Services Modernization Act of 1999 allowed many of the banks' closest competitors to offer a wide array of financial services thereby taking away market share from "traditional" banks. Banks and their closest competitors are converging into one-stop shopping for financial services and this trend should continue in the future

1-6. What different kinds of services do banks offer the public today? What services do their closest competitors offer?

Banks offer the widest range of services of any financial institution. They offer thrift deposits to encourage saving and checkable (demand) deposits to provide a means of payment for purchases of goods and services. They also provide credit through direct loans, by discounting the notes that business customers hold, and by issuing credit guarantees. Additionally, they make loans to consumers for purchases of durable goods, such as automobiles, and for home improvements, etc. Banks also manage the property of customers under trust agreements and manage the cash positions of their business customers. They purchase and lease equipment to customers as an alternative to direct loans. Many banks also assist their customers with buying and selling securities through discount brokerage subsidiaries, the acquisition and sale of foreign currencies, the supplying of venture capital to start new businesses, and the purchase of annuities to supply future funding at retirement or for other long-term projects such as supporting a college education. All of these services are also offered by their closest competitors. Banks and their closest competitors are converging and becoming the financial department stores of the modern era.

1-7. What is a financial department store? A universal bank? Why do you think these institutions have become so important in the modern financial system?

Financial department store and universal bank refer to the same concept. A financial department store is an institution where banking, fiduciary, insurance, and security brokerage services are unified under one roof. A bank that offers all these services is normally referred to as a universal bank. These have become important because of convergence and changes in regulations that have allowed financial service providers to offer all services under one roof

1-8. Why do banks and other financial intermediaries exist in modern society, according to the theory of finance?

There are multiple approaches to answering this question. The traditional view of banks as financial intermediaries sees them as simultaneously fulfilling the financial-service needs of savers (surplus-spending units) and borrowers (deficit-spending units), providing both a supply of credit and a supply of liquid assets. A newer view sees banks as delegated monitors who assess and evaluate borrowers on behalf of their depositors and earn fees for supplying monitoring services. Banks also have been viewed in recent theory as suppliers of liquidity and transactions services that reduce costs for their customers and, through diversification, reduce risk. Banks are also critical in the payment system for goods and services and have played an increasingly important role as a guarantor and a risk management role for customers.

1-9. How have banking and the financial services market changed in recent years? What powerful forces are shaping financial markets and institutions today? Which of these forces do you think will continue into the future?

Banking is becoming a more volatile industry due, in part, to deregulation which has opened up individual banks to the full force of the financial marketplace. At the same time the number and variety of banking services has increased greatly due to the pressure of intensifying competition from nonbank financial-service providers and changing public demand for more conveniently and reliably provided services. Adding to the intensity of competition, foreign banks have enjoyed success in their efforts to enter countries overseas and attract away profitable domestic business and household accounts.

1-10. Can you explain why many of the forces you named in the answer to the previous question have led to significant problems for the management of banks and other financial firms and their stockholders?

The net result of recent changes in banking and the financial services market has been to put greater pressure upon their earnings, resulting in more volatile returns to stockholders and an increased bank failure rates. Some experts see banks' role and market share shrinking due to restrictive government regulations and intensifying competition. Institutions have also become more innovative in their service offerings and in finding new sources of funding, such as off-balance-sheet transactions. The increased risk faced by institutions today, therefore, has forced managers to more aggressively utilize a wide array of tools and techniques to improve and stabilize their earnings streams and manage the various risks they face.

1-11. What do you think the financial services industry will look like 20 years from now? What are the implications of your projections for its management today?

There appears to be a trend toward continuing consolidation and convergence. There are likely to be fewer financial service providers in the future and many of these will be very large and provide a broad range of financial services under one roof. In addition, global expansion will continue and will be critical to the survival of many financial service providers. Management of financial service providers will have to be more technologically astute and be able to make a more diverse set of decisions including decisions about mergers, acquisitions and global expansion as well as new services to add to the firm.

Problems and Projects

1. You have just been hired as the marketing officer for the new First National Bank of Vincent, a suburban banking institution that will soon be serving a local community of 120,000 people. The town is adjacent to a major metropolitan area with a total population of well over 1 million. Opening day for the newly chartered bank is just two months away, and the president and the board of directors are concerned that the new bank may not be able to attract enough depositors and good-quality loan customers to meet its growth and profit projections. There are 18 other financial-service competitors in town, including two credit unions, three finance companies, four insurance agencies, and two security broker offices. Your task is to recommend the various services the bank should offer initially to build up an adequate customer base. You are asked to do the following:

- a. Make a list of all the services the new bank could offer, according to current regulations.
- b. List the type of information you will need about the local community to help you decide which of the possible services are likely to have sufficient demand to make them profitable.
- c. Divide the possible services into two groups--those you think are essential to customers and should be offered beginning with opening day, and those that can be offered later as the bank grows.
- d. Briefly describe the kind of advertising campaign you would like to run to help the public see how your bank is different from all the other financial service providers in the local area. Which services offered by the nonblank service providers would be of most concern to the new bank's management?

Banks can offer, if they choose, a wide variety of financial services today. These services are listed below. However, unless they are affiliated with a larger bank holding company and can offer some of these services through that company, it may be more limited in what it can offer.

Regular Checking Accounts	Management Consulting Services
NOW Accounts	Letters of Credit
Passbook Savings Deposits	Business Inventory Loans
Certificates of Deposit	Asset-Based Commercial Loans
Money Market Deposits	Discounting of Commercial Paper
Automobile Loans	Plant and Equipment Loans
Retirement Savings Plans	Venture Capital Loans
Nonauto Installment Loans to Individuals	Leasing Plans for Business Property
Residential Real Estate Loans	and Equipment
Home Improvement Loans	Security Dealing and Underwriting
Personal Trust Management Services	Discount Security Brokerage
Commercial Trust Services	Foreign Currency Trading and
Institutional Trust Services	Exchange
Personal Financial Advising	Personal Cash-Management Services
Insurance Policy Sales (Mainly Credit-Life)	Standby Credit Guarantees
Insurance Today (Except in Some States))	Acceptance Financing

To help the new bank decide which services to offer it would be helpful to gather information about some of the following items in the local community:

School Enrollments and Growth in School Enrollments
Estimated Value of Residential and Commercial Property
Retail Sales
Percentage of Home Ownership Among Residents in the Area
Number and Size (in Sales and Work Force) of Local Business Establishments
Major Population Locations (i.e., Major Subdivisions, etc.) and Any Projected Growth Areas
Population Demographics (i.e., Age Distribution of the Area)
Projected Growth Areas of Industries in the Area

Essential services the bank would probably want to offer right from the beginning includes:

Regular Checking Accounts	Home Improvement Loans
Automobile and other Consumer-type	Money Market Deposit Accounts
Installment Loans	Retirement Savings Plans
NOW Accounts	Business Inventory Loans
Passbook Savings Deposits	Discounting of High-Quality Commercial Notes
Residential Real Estate Loans	
Certificates of Deposit	

As the bank grows, opportunities for the profitable sale of additional services usually increase, especially for trust services for individuals and smaller businesses and personal financial advising as well as some commercial (plant and equipment) loans and leases. Further growth may result in the expansion of commercial trust services as well as a widening variety of commercial loans and credit guarantees.

The bank would want to develop an advertising campaign that sends a message to potential customers that the new bank is, indeed, different from its competitors. Small banks often have the advantage of offering highly personalized services in which their customers are known and recognized and services are tailored to each individual customer's special financial needs. Quality and reliability of banking service are often more important to individual customers than is price. A new bank must try to sell prospective customers, most of who will come from other banks in the area, on personalized services, quality, and reliability - all three of which should be emphasized in its advertising program.

2. Leading money center banks in the United States have accelerated their investment banking activities all over the globe in recent years, purchasing corporate debt securities and stock from their business customers and reselling those securities to investors in the open market. Is this a desirable move by these banking organizations from a profit standpoint? From a risk standpoint? From the public interest point of view? How would you research their question? If you were managing a corporation that had placed large deposits with a bank engaged in such activities, would you be concerned about the risk to your company's funds? What could you do to better safeguard those funds?

In the 1970's and early 1980's investment banking was so profitable that commercial bankers were lured into the investment banking business largely because of its greater profit potential than possessed by more traditional commercial banking activities. Later foreign banks, particularly the British and Japanese banking firms, began to attract away large corporate customers from U.S. banks, who were restrained by regulation from offering many investment banking services. Thus, U.S. banks ran into severe difficulty in simply trying to hold onto their traditional corporate credit and deposit accounts because they could not compete service-wise in the investment banking field. Today, banks are allowed to underwrite securities through either a subsidiary or through a holding company structure. This change occurred as part of the Gramm-Leach-Bliley Act (Financial Services Modernization Act).

Unfortunately, if investment banking is more profitable than traditional banking product lines, it is also more risky, consistent with the basic tenet of finance that risk and return are directly related. That is why the Federal Reserve Board has placed such strict limits on the type of organization that can offer these services. Currently, the underwriting of most corporate securities must be done through a subsidiary or as a separate part of the holding company so that, in theory at least, the bank is not responsible for any losses incurred. For this reason there may be little reason for depositors (including large corporate depositors) to be concerned about risk exposure from investment banking. Moreover, the ability to offer such services may make U.S. banks more viable in the long run which helps their corporate customers who depend upon them for credit.

On the other hand, opponents of investment banking powers for bank operations inside the U.S. have some reasonable concerns that must be addressed. There are, for example, possible conflicts of interest. Information gathered in the investment banking division could be used to the detriment of customers purchasing other bank services. For example, a customer seeking a loan may be told that he or she must buy securities from the bank's investment banking division in order to receive a loan. Moreover, banks could gain effective control over some nonblank industrial corporations which might subject them to added risk exposure and place industrial firms not allied with banks at a competitive disadvantage. As a result the Gramm-Leach-Bliley Act has built in some protections to prevent this from happening.

3. The term *bank* has been applied broadly over the years to include a diverse set of financial-service institutions, which offer different financial service packages. Identify as many of the different kinds of “banks” as you can. How do the “banks” you have identified compare to the largest banking group of all – the commercial banks? Why do you think so many different financial firms have been called *banks*? How might this terminological confusion affect financial-service customers?

The general public tends to classify anything as a bank that offers some sort of financial service, especially deposit and loan services. Other institutions that are often referred to as a bank without being one are savings associations, credit unions, money market funds, mutual funds, hedge funds, security brokers and dealers, investment banks, finance companies, financial holding companies and life and property/casualty insurance companies. All of these institutions offer some of the services that a commercial bank offers, but generally not the entire scope of services. Since providers of financial services are normally called banks by the general public they are able to take away business from traditional banks and it is of utmost importance for commercial banks to clarify their unique position among financial services providers.

4. What advantages can you see to banks affiliating with insurance companies? How might such an affiliation benefit a bank? An insurer? Can you identify any possible disadvantages to such an affiliation? Can you cite any real world examples of bank-insurer affiliations? How well do they appear to have worked out in practice?

Before Glass-Steagall banks used to sell insurance services to their customers on a regular basis. In particular, banks would sell life insurance companies to loan customers to ensure repayment of the loan in case of death or disablement. These reasons still exist today and the right to sell insurances to customers again benefits banks in allowing them to offer their customers complete financial packages from financing the home or car to insure it, from giving investment advice to selling life insurance policies and annuities for retirement planning. Generally, a bank customer who is already purchasing a service from a bank might feel compelled to purchase an insurance product, as well. On the other hand, insurance companies sometimes have a negative image, which makes it more difficult to sell certain insurance products. Combining their products with the trust that people generally have in banks will make it easier for them to sell their products. The most prominent example of a bank-insurer affiliation is the merger of Citicorp and Traveler's Insurance to Citigroup. However, given that Citigroup has sold Traveler's Insurance indicates that the anticipated synergy effects did not materialize.

5. Explain the difference between *consolidation* and *convergence*. Are these trends in banking and financial services related? Do they influence each other? How?

Consolidation refers to increase in the size of financial institutions and the decline in the number of small independently owned banks and financial service providers. Convergence is the bringing together of firms from different industries to create conglomerate firms offering multiple services. Clearly, these two trends are related. In their effort to compete with each other, banks and their closest competitors have acquired other firms in their industry as well across industries to provide multiple financial services in multiple markets.

6. What is a *financial intermediary*? What are their key characteristics? Is a bank a type of financial intermediary? Why? What other financial-services companies are financial intermediaries? What important role within the financial system do financial intermediaries play?

A financial intermediary is a business that interacts with deficit spending individuals and institutions and surplus spending individuals and institutions. For that reason any financial service provider (including banks) is considered a financial intermediary. In their function as intermediaries they act as a bridge between the deficit and surplus spending units by offering financial services to the surplus spending individuals and then loaning those funds to the deficit spending individuals. Financial intermediaries accelerate economic growth by increasing the pool of available funds and lowering the risk of investments through diversification.