
Chapter 1: Functions and Forms of Banking

This chapter provides an overview of the banking system and of the changing role of commercial banks. It begins with a discussion of how the legal definition of a bank has changed over time, the range of services provided by banks, and the various types of banks. Next, the focus shifts to the basic activities of commercial banks—providing for an efficient payments mechanism, intermediation between lenders and borrowers, and performing other financial services such as off-balance sheet risk taking, securities related services, and so on. It points out that, like most other businesses, banks exist to provide a return to shareholders. In that regard banks must balance the profitability of lending and investing and providing other financial services with the risks involved in those activities. However, in balancing risk and return, banks not only face market constraints, but they also are confronted with social, legal, and regulatory constraints.

This chapter provides extensive information on the sizes and market shares of commercial banks and other financial service firms. A key point here is that the market share of banks has declined considerably over time. Changes in the market shares of financial institutions reflect a number of factors including inflation and high and volatile interest rates, securitization, technological advances, changes in consumer behavior patterns, competition, deregulation, despecialization, and globalization.

This chapter also presents the major assets and liabilities of commercial banks and discusses the banking functions that create those assets and liabilities. Finally, bank profitability, and some of the factors that affect it – economic growth, increased risk, fee income, and efficiency – are presented.

Outline of the Chapter

What is a Bank?

What Do Banks Do for their Customers?

- Payments

- Financial Intermediation

- Other Financial Services

Banks are Private Firms With a Public Purpose

- Bank Risk Management

- Constraints

Sizes and Market Shares of Commercial Banks and Other Financial Service Firms

Major Factors Affecting Banking and Market Shares

- Inflation and Volatile Interest Rates

- Securitization

- Technological Advances

- Consumers

- Deregulation

- Despecialization and Competition

- Globalization

- Money and Capital Markets

Assets and Liabilities of Commercial Banks

- Assets

- Deposits

- Equity

Bank Profitability

- Economic Growth

- Increased Risk

- Fee Income

- Efficiency

Summary

Key Terms and Concepts

Questions

Key Terms and Concepts

- Bank (definition, functions, types)

- Bank risk management

- Concentration of banks

- Consumer protection

- Credit risk

- Deregulation

- Globalization

- Economies of scale and scope

- Intermediation (financial)

- Interest rate risk

- Liquidity risk

- Off-balance sheet risks

- Payments system

- Securitization

- Too-Big-To-Fail doctrine

Questions

- 1.1 It is sometimes argued that bank managers are fundamentally involved in risk management. In what sense are they risk managers? Is their risk management similar to or different from that of managers of manufacturers and other nonfinancial firms?

ANSWER: Banks differ from manufacturing, wholesale, and retail firms (and from service firms), in their relationship with risk. Those nonfinancial firms essentially provide for the manufacturing and distribution of goods (service firms are, of course, involved in providing services to their customers and in the course of performing their basic economic functions are forced to take various types of risk). However, the taking of risk is incidental to their place in the economic system. In contrast, banks exist to take risk. Without taking risk they would earn no profit and eventually cease to exist. They accept risk in order to earn an acceptable profit. Risk is thus inherent to their role as

economic agents. The essence of bank management is balancing the amount of credit, interest rate, liquidity, and other types of risk in order to earn an acceptance return.

1.2 How do commercial banks differ from other types of depository institutions such as credit unions?

ANSWER: A commercial bank is an organization that is given a banking charter by the state or the federal government. A commercial bank has FDIC insured deposits and makes loans. Credit unions are not chartered as banks, nor do they have FDIC insured deposits. Nevertheless, credit unions and financial service firms provide many of the same services as banks, but they are not necessarily covered by the same laws or regulations. For example, credit unions do not pay tax and they are not subject to the Community Reinvestment Act (CRA).

1.3 List three broad functions of commercial banks. What other financial institutions compete with banks in providing these services to the public?

ANSWER: The main functions of banks are (1) payments, (2) intermediation, and (3) other financial services. Numerous financial institutions compete with banks in providing these services. For example, other depository institutions provide payments mechanisms as do money market mutual funds and many securities brokerage firms. The Merrill Lynch Cash Management Account (CMA) is an excellent example.

1.4 What is the principal goal of a commercial bank? How does profitability of a bank and the risks it faces affect this goal?

ANSWER: Banks seek to maximize the market value of equity of common shareholders. Of course, profits on operations will increase share price, holding all risks constant. In practice, banks face a variety of risks, such as credit risk on loans, interest rate risk associated with changes in the value of its financial assets and liabilities as interest rate change, liquidity risk that occurs because assets might have to be sold at a relatively large discount from their original value, operations risk that their expenses might be too high, and so on.

There is an expected tradeoff between risk and return. In the late 1990s, banks increased their risk by taking on more real estate loans. Because the economy was prosperous, the increased risk paid-off in terms of higher profits.

1.5 What are the principal factors that have affected the operations of commercial banks in recent years? Which (if any) of these are under the control of bank management?

ANSWER: The principal factors that have affected the operations of commercial banks in recent years include: (1) inflation and high and volatile interest rates. Although interest rates declined sharply in the early 1990's, the high and volatile interest rates of the 1970's and 1980's produced innovations in financial markets that eroded the market

share of commercial banks. (2) securitization. This has allowed banks to decompose the lending process (unbundle it) and have greater access to the capital markets. (3) technological advances. A transformation in the technology involved in the delivery of financial services, especially a decline in the cost of delivery, has had a significant impact on commercial banks (4) more sophisticated customers making banking markets more efficient and making it more difficult for banks to earn an acceptable risk adjusted return. (5) Securitization, which led to funds flowing directly to the capital markets and around commercial banks. To the extent that banks are involved in these markets, their role is as an origination of credit (for which they earn fee income) rather than as a lender. (6) Increased competition from the capital markets. (7) Deregulation, especially deposit rate deregulation. (8) Despecialization, which has led to financial service organizations providing a portfolio of financial services. Improved communication and computer technology has also played a role in decompartmentalization. (9) Globalization, which has markedly increased the degree of competition in financial markets, especially in the United States.

With the exception of securitization, banks have little control over these factors. What bank managers can control is their reaction to these events. Thus, they can choose alternative strategies to react to greater competition from domestic and international rivals and they can also adopt the new technology with varying degrees of speed.

1.6. What risk historically accounts for most bank failures?

ANSWER: The principal reason that banks fail is that they loans that went bad. I always make the point that banks to not intentionally set out to make bad loans. However, over time, economic conditions can change and borrowers default. More will be said about this in the next chapter.

1.7. What constraints do banks face in achieving their goals(s)?

ANSWER: There are two general types of constraints: (1) social and (2) legal and regulatory. The former constraint stems from the central role banks play in community development and the stability of the nation's economy. The second constraint derives from the large number of limits placed on them in the areas of balance sheet composition, pricing, geographic expansion, entry into a market, and customer relationships. These constraints are designed to reduce the risk of bank failure and to protect the public in their dealing with banks.

1.8. Discuss market share trends over time among commercial banks.
Why has the market share of banks fallen?

ANSWER: The market share of commercial banks (measured as the proportion of the flow of funds that take place through the banking system) has declined significantly. Indeed, the share of depository institutions (commercial banks, savings and loans, savings banks, and credit unions taken as a group) has declined. The changes in the external environment that are discussed in q. 1.5 have been important in affecting bank market share, particularly changing technology and securitization.

1.9. What is meant by securitization?

ANSWER: Securitization refers to the process of turning unmarketable and illiquid assets (usually loans) into marketable and liquid securities. The best example of securitization is the development of mortgage backed securities for single family residential home loans. Other examples include, auto loans, credit card loans, and some commercial loans.

1.10. What are the principal assets and liabilities of commercial banks? How have they changed over time?

ANSWER: The two principal bank assets are loans and securities. Banks make most of their income from loans. In recent years they have shown a strong preference for real estate loans. This is due in part to the declining role of savings and loan associations. The next largest category is commercial and industrial loans, and then consumer loans.

The principal bank liabilities are deposits. Transactions accounts (i.e. demand deposits and negotiable order of withdrawal) account for about 18% of total deposits. The significance of transaction accounts has diminished as other financial institutions have offered these types of accounts in competition with commercial banks.

1.11 What are some of the major external and internal factors that affect bank profits?

ANSWER: External: Bank profitability is determined primarily by the state of the economy that it serves. If the economy is doing well, banks will prosper. Internal: Risk is a major factor affecting expected profits. Higher risks suggest higher expected profits. That worked fine for banks in the late 1990s because of the strong economy. In addition, banks have turned increasingly to fee income in both business and consumer accounts. Finally, they have become more efficient in terms of their internal operations.

True-False

1.1. Banks can be uniquely defined in terms of offering transaction accounts and making commercial loans.

ANSWER: False

1.2 The payments role of commercial banks include both offering transaction accounts and being ready to make wire transfers.

ANSWER: True

1.3 A wholesale bank is one that both draws funds from businesses and makes loans primarily to businesses.

ANSWER: True

1.4 Equity capital is bank's major source of funds.

ANSWER: False

- 1.5 Since banks rely upon the trust of their customers many banks are often referred to as “trust” banks.

ANSWER: False

- 1.6 The Glass-Steagall Act authorized banks to engage in securities activities.

Answer: False

- 1.7 The standby letter of credit is one of the best known of the various off-balance sheet activities of commercial banks.

ANSWER: True

- 1.8 Risk management is an important though peripheral activity for most commercial banks.

ANSWER: False

- 1.9 Most regulatory constraints on bank behavior are designed either to reduce the risk of failure or to affect the price and allocation of bank credit.

ANSWER: True

- 1.10 Commercial banks have experienced a substantial increase in their market share.

ANSWER: False

- 1.11 Securitization refers to the process of making some of the loan portfolio marketable by establishing pools of loans and selling interests (i.e., securities) in the pool.

ANSWER: True

- 1.12 The effects of despecialization of financial services have been more evident at nonbank firms than at commercial banks.

ANSWER: True

- 1.13 Commercial bank assets exceed 50 percent of all financial sector assets.

ANSWER: False

- 1.14 The largest type of bank assets is in the form of securities

ANSWER: False

- 1.15 The largest source of banks funds is the demand deposit accounts of individuals, businesses, and governments

Multiple Choice

1.1. In the past 20 years, the range of financial service has:

- a. expanded considerable
- b. remained relatively constant
- c. declined considerable
- d. decline slightly

ANSWER: a

1.2 Which of the following is NOT a function of commercial banks?

- a. intermediation
- b. payments
- c. deposit insurance
- d. real estate related activities

ANSWER: c

1.3 Commercial banks offer fiduciary services in order to:

- a. increase the amount of assets on their balance sheet without adding risk
- b. comply with federal regulations
- c. service employee pension and profit sharing programs
- d. maximize interest income

ANSWER: c

1.4 Commercial banks do not engage in which of the following securities related services?

- a. discount brokerage services
- b. underwriting corporate stocks and bonds
- c. underwriting U. S. Treasury securities
- d. facilitating mergers and acquisitions

ANSWER: b

1.5 Off-balance sheet risk taking involves:

- a. underwriting U. S. Treasury securities
- b. offering fiduciary services
- c. seeking capital gains from corporate stocks
- d. generating fee income by assuming contingent liabilities

ANSWER: d

1.6 Which of the following is prohibited for commercial banks?

- a. real estate investment
- b. insurance underwriting
- c. corporate bond underwriting
- d. all of the above

ANSWER: e

1.7 The largest use of funds for a commercial bank is:

- a. savings deposits
- b. loans
- c. time deposits
- d. securities

ANSWER: b

- 1.8 Which of the following is most important to commercial bank management?
- a. increasing the bank's total size
 - b. maintaining a minimum amount of risk
 - c. profits from financial services (adjusted for risk)
 - d. out-performing other depository institutions

ANSWER: c

- 1.9 Which of the following is NOT included in the total risk of a commercial bank?
- a. depository risk
 - b. credit risk
 - c. interest rate risk
 - d. reputation risk

ANSWER: a

- 1.10 Which of the following is an example of fraud risk?
- a. a bank officer falsifying records
 - b. a customer writes several bad checks and leaves town
 - c. a depositor fails to report a clerical error in his favor
 - d. all of the above

ANSWER: a

- 1.11 The social constraints imposed on banks are:
- a. exemplified by the Community Reinvestment Act
 - b. due to the historical position of the bank as the core of the financial system
 - c. regulated by the federal reserve bank
 - d. regulated by the FDIC

ANSWER: a

- 1.12 Which of the following is NOT a legal constraint placed on commercial banks?
- a. constraints on entry
 - b. constraints on loan composition
 - c. constraints on balance sheet composition
 - d. constraints on geographic expansion

ANSWER: b

- 1.13 The constraints on commercial banks:
- a. are the result of the banking collapse of the 1930's
 - b. affect the price and allocation of bank credit

- c. are designed to reduce risk of failure
- d. all of the above

ANSWER: d

1.14 The approximate number of banks in the United States is:

- a. 12,000
- b. 10,000
- c. 8,000
- d. 6,000

ANSWER: c (as of 1999)

1.15 Banks are regulated in order to do all of the following EXCEPT.

- a. achieve desired social goals
- b. achieve concentration of banks
- c. prevent monopoly
- d. prevent banking market failure

ANSWER: b

1.16 Economies of scale are evident in:

- a. credit card lending
- b. farm lending
- c. wholesale banking
- d. universal banking

ANSWER: a

1.17 Which of the following is NOT a reason for the increased competition between financial institutions?

- a. the increased concentration among nonbank institutions
- b. all depository institutions are now allowed to offer transactions accounts
- c. the expansion of services offered by financial and nonfinancial conglomerates
- d. the elimination of deposit rate ceilings

ANSWER: a

1.18 Low levels of interest rates in the late 1990s forced banks to increase profitably by:

- a. reducing the size of the bank's loan portfolio
- b. making investments in stocks and bonds
- c. increasing fee income
- d. raising the efficiency ratio

ANSWER: c

1.19 The decline in market share for commercial banks is the result of:

- a. growing competition from nonbank institution
- b. securitization
- c. a fractured banking structure

- d. a, b

ANSWER: a

1.20 Globalization of the financial system involves:

- a. the expanding number of services offered by banks
- b. the increasing links between U. S. and foreign markets
- c. the increasing competition in the U. S. among domestic banks
- d. b, c

ANSWER: b

1.21 Bank managers today operate in an environment of _____ risk and face a more _____ financial world than in the past.

- a. credit; globalized
- b. greater; complicated
- c. less; stabilized
- d. greater; stabilized

ANSWER: b

1.22 Profitability _____ in the banking industry, while the number of bank failures _____ in the 1990s.

- a. declined; stabilized
- b. increased; declined
- c. declined; increased
- d. declined; declined

ANSWER: b

1.23 Which of the following is not a function generally provided by commercial banks?

- a. provide a means of payment
- b. provide management services for commercial real estate
- c. provide for intermediation between savings and borrowers
- d. provide trust services

ANSWER: b

1.24 Which of the following is not a component of total risk for a bank?

- a. credit risk
- b. capital risk
- c. systematic risk
- d. interest rate risk

ANSWER: c

1.25 Which of the following accurately describes the process of securitization?

- a. the process of substituting securities for deposits in bank balance sheets
- b. the process of making some or all of the loan portfolios marketable by establishing pools of loan interest (securities) in the pool
- c. the process of buying securities

- d. none of the above

ANSWER: b

- 1.26 The two largest categories of bank loans are:
- business and real estate loans
 - consumer loans and real estate loans
 - loans to purchase securities and business loans
 - business and consumer loans

ANSWER: a

Case

The Policy Consultant (Part 1)

Jack Anderson is a policy consultant for North Information Services (NIS), a firm that specializes in lobbying Congress for banks and financial institutions that want to protect their economic interests. Mr. North, President and C.E.O. of NIS asked Jack to prepare a brief for one of their major clients, an international bank, on the major issues that Congress will address this next term. For the first part of his brief, Jack is going to begin his research for the brief by reviewing the following sources of information concerning banking issues that are available on the internet:

- Speeches and testimony by members of the Board of Governors of the Federal Reserve System: <http://www.federalreserve.gov>,
- Current Federal legislation in the U.S. House Committee on Financial Services: (<http://www.house.gov>),
- The Bank for International Settlements deals with international issues (See <http://www.bis.org>).

Based on these and other sources that he finds, Jack wants to determine:

1. What are the current major issues facing domestic banks and their regulators?
2. Because the client is an international bank, what are the current major issues facing international banks and their regulators?
3. How might these issues affect the client?

Case Notes:

This case is what is referred to as a “live case.” It deals with current issues that are subject to change. The case requires students to use internet resources to examine selected topics dealing with banking issues. The issues, their pros and cons, and how they might affect an international bank can be used as a basis of classroom discussion, and for written reports.