CHAPTER 5: COMMERCIAL BANKS

Lecturer: MBS Nguyen Thi Hong Nguyen

Sources:

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1. DEFINITION OF COMMERCIAL BANK

- Definition of banking
- Definition of commercial bank
- Functions of commercial banks

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DEFINITION OF BANKING

- Banking is defined as accepting deposits of money from public for the purpose of lending or investment, these deposit are repayable on demand or otherwise, and withdrawable by cheque, draft or order otherwise.

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THE DEFINITION OF COMMERCIAL BANKING

- Commercial bank is a financial institution that provides packages of financial services, especially deposit and loan products as well as payment services.
- Commercial banks serve surplus units by offering a wide variety of deposit accounts, and they transfer the deposited funds through deficit units by providing direct loans or purchasing debt securities.

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FUNCTIONS OF COMMERCIAL BANKS

- Intermediary
- Payments
- Create “money”

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INTERMEDIARY

- The core activity of commercial banks is to act as intermediaries between depositors and borrowers.
- Intermediary role presented in 2 forms:
  - Brokerage function
  - Transformation services

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INTERMEDIARY

- Brokerage function is represented by the activities of brokers and market operators, processing and supplying information.
- Brokerage function brings together lenders and borrowers and reduces market imperfections such as search, information and transaction costs.

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INTERMEDIARY

- Transformation services: commercial banks combine various types of transformation services with financial intermediation:
  - Liability, asset and size transformation
  - Maturity transformation
  - Risk transformation

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PAYMENTS

- Banks provides transaction services that enable them a centre position in payment system:
  - Banks convert deposits into notes and coins to enable holders of deposits to undertake transactions in cash.
  - Bank deposits are used as a means of settling debts.
  - Where exchange controls do not exist, banks exchange cash and deposits from one currency into cash and deposits of another currency.

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PAYMENTS

- Commercial banks nowadays have electronic payment system which is replacing paper based payment methods.
- They have settlement system and integrated payment system to reduce transaction cost and increase the efficiency of conducting monetary policy.

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MONEY CREATION

- Banks create money by loaning out money that was deposited with them.
- Example:
  - A deposits $100 at the bank.
  - With the required reserve ratio of 10% set by the central bank, the bank could loan out $90 to B.
  - At this point, A has $100 and B has $90 in purchasing power. So the money supply has essentially increased from $100 to $190, thus "creating" money.
  - Further creation of money when B deposit his $90 to a bank and the bank with reserve ratio of 10% could lend $81 do C, etc…

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2. TYPE OF COMMERCIAL BANKS

- By the ownership
- By the operational characteristics
- By the structure

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TYPES OF COMMERCIAL BANKS BY OWNERSHIP

- State own commercial banks (SOCBs)
- Joint stock commercial banks
- Private banks
- Joint venture banks
- Foreign owned banks

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TYPES OF COMMERCIAL BANKS BY OPERATIONAL CHARACTERISTICS

- Universal banks vs. Traditional banks
- Wholesale banking vs. Retail banking

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UNIVERSAL BANKING VS. TRADITIONAL BANKING

- Traditional commercial banking refers to the banking activities in which banks act ac intermediation between borrowers and lenders, and offer payment service to its customers.

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UNIVERSAL BANKING VS. TRADITIONAL BANKING

- Universal banking offers the full range of banking services, together with non-banking financial services, under one legal entity.
- Financial services that an universal bank could offer:
  - Intermediation and liquidity via deposits and loans; a byproduct is the payments system.
  - Trading of financial instruments (e.g., bond, equity, currency) and associated derivatives.
  - Proprietary trading, that is, trading on behalf of the bank itself, using its own trading book.
  - Stockbroking.
  - Corporate advisory services, including mergers and acquisitions.
  - Investment management.
  - Insurance.

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UNIVERSAL BANKING VS. TRADITIONAL BANKING

- Commercial banks vs. Investment banks:
  - The Glass Steagall Act in the US,1933 separated investment banking and commercial banking activities:
    - commercial banks were not allowed to underwrite securities with the exception of municipal bonds, US government bonds and private placements
    - Investment banks were prohibited from offering commercial banking services.
  - Activities of investment banks:
    - underwriting
    - mergers and acquisitions
    - trading – equities, fixed income (bonds), proprietary
    - fund management
    - Consultancy
    - global custody
  - the Glass Steagall Act removed by The Gramm Leach Bliley Financial Modernisation (GLB) Act in late 1999

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WHOLESALE BANKING VS. RETAIL BANKING

- Wholesale banking typically involves offering intermediary, liquidity and payment services to large customers such as big corporations and governments.
- They offer business current accounts, make commercial loans, participate in syndicated lending and are active in the *interbank markets* to borrow/lend from/to other banks.

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WHOLESALE BANKING VS. RETAIL BANKING

- Retail banking offers the same services to numerous personal banking customers and small businesses.
- Retail banking is largely intrabank: the bank itself accepts deposits and makes many small loans.
- It tends to be domestic, though the information technology revolution has the potential to break down national barriers.

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TYPES OF COMMERCIAL BANKS BY STRUCTURE

- According to the US law, Bank holding company (BHC) is a firm that owns at least 25% voting stock of a bank subsidiary in two or more banks. Each BHC owns banking subsidiaries, which are legally separate and individually capitalised.
- Financial holding companies (FHCs) are the firms own subsidiary commercial banks, investment banks and insurance firms.

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3. BANK SOURCES OF FUNDS

- Deposit accounts
  - Transaction deposits
  - Saving deposits
  - Time deposits
- Borrowed funds
  - Federal funds purchased (borrowed)
  - Borrowing from the Central banks
  - Repurchase agreements
  - Eurodollar borrowings
- Long term sources of funds
  - Bonds issued by the banks
  - Bank capital

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TRANSACTION DEPOSIT

- Demand deposit account (checking account):
  - Offer to customers who want to write check against their accounts
  - Require small minimum balance and require no interest
- Negotiable order of withdrawal (NOW) account:
  - Pays interest as well as providing checking services
  - Normally, requires higher minimum balance that demand deposit account.

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SAVINGS DEPOSIT

- The traditional savings account is the passbook savings account, which does not permit check writing
- Passbook savings accounts have no required minimum balance.

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TIME DEPOSIT

- Time deposits are deposit that can not be withdrawn until a specified maturity date.
- Two most common types of time deposits are:
  - Certificate of deposit
  - Negotiable certificate of deposit

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FEDERAL FUND PURCHASED (BORROWED)

- Federal fund purchased represents a liability to the borrowing bank and an asset to the lending bank.
- Actually, it's just like an interbank short term loan with maturity from 1 to 7 days.

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BORROWING FROM THE CENTRAL BANK

- A temporary source of fund for bank, in which the bank borrows short-term from the central bank. (also called borrowing at the discount window)
- Interest rate on this kind of loan called *primary credit lending rate.*
- Maturity from 1 day to few weeks.

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EURODOLLAR BORROWING

- When US bank need short term source of fund, it can borrow from banks outside the US that provide eurodollars, the dollar-denominated deposits.

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BONDS ISSUED BY THE BANK

- To purchase for long term need of funds, bank issue bonds.
- However, the long term need of funds of the bank is less than other types of corporations so bonds issued by bank are fewer.

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BANK CAPITAL

- Bank capital generally represent funds attained through the issuance of stocks or through retaining earnings.
- A bank's capital must be sufficient to absorb operating losses in the event that expenses and losses exceed revenues.
- Bank regulators have restrict regulation of the minimum level of bank capital.

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4. USES OF FUNDS BY BANKS

- Cash
- Bank loans
- Investment in securities
- Federal funds sold (loaned out)
- Repurchase agreements
- Eurodollar loans
- Fixed assets

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CASH

- Banks must hold some cash as reserves to meet the reserve requirements enforced by the central bank.
- Banks hold some cash to maintain the liquidity and accommodate any withdrawal request by depositors.

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BANK LOANS

- Business loans
- Consumer loans
- Real estate loans

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BUSINESS LOANS

- Working capital loan
- Term loan
  - Amortised loan
  - Bullet loan
- Direct lease loan
- Informal line of credit
- Loan participation

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CONSUMER LOANS

- Instalment loan
- Credit cards

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INVESTMENT IN SECURITIES

- Treasury and agency securities
- Corporate and municipal bonds
- Mortgage backed securities

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FEDERAL FUNDS SOLD (LOANDED OUT)

- Lending to other banks in federal funds market.
- Maturity is usually short.

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EURODOLLAR LOANS

- The loan denominated in dollar provided by branches of US bank outside the country and foreign owned bank.

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FIXED ASSETS

- Banks must maintain some amount of fixed assets, like building and land, so that they could conduct their operation

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5. OFF-BALANCE SHEET ACTIVITIES

- Off-balance sheet activities are activities generates fee income without requiring an investment of funds.
- Types of off-balance sheet activities:
  - Loan commitments
  - Standby letters of credit
  - Forward contract on currencies
  - Interest rate swap contracts
  - Credit default swap contracts

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LOAN COMMITMENTS

- A loan commitment is an obligation by bank to provide a specified amount to a particular firm upon the firm's request.
- Banks earn fee from the commitments
- It could have liquidity problem when too many firms request for funds at the same time.

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STANDBY LETTER OF CREDIT

- Standby letter of credit (SLC) back a customer's obligation to a third party. If the customer does not meet the obligation, the bank will.

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FORWARD CONTRACT ON CURRENCIES

- A forward contract on currencies is an agreement between a customer and a bank to exchange on currency for another on a particular date at a specified exchange rate.

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INTEREST RATE SWAP CONTRACTS

- Bank serve as intermediary for interest rate swaps, whereby 2 parties agree to periodically exchange interest payments on a specified notional amount of principal.
- Bank receive transaction fee for the service
- If it guarantees payments for both parties, it is exposed to the possibility that one of the party default on its obligation, in that case, bank must assume the role of that party and fulfil the obligation to the other party.

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CREDIT DEFAULT SWAP CONTRACTS

- Credit default swap contract is the privately negotiated contract that protect investors against the risk of default on particular debt securities.
- Some banks buy it to protect the default risk of debt securities, others sell it.
- The bank that sell it receive periodic coupon payments for the term of the swap agreement
- If there is no default on debt securities then the bank who sell CDS get benefits, otherwise, they have to make payment to buyer to cover the damages.

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6. RISK MANAGEMENT IN BANKING

- Credit risk
- Interest rate risk
- Liquidity risk
- Other risks

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CREDIT RISK

- Credit risk is the risk that an asset or a loan becomes irrecoverable in the case of outright default, or the risk of an unexpected delay in the servicing of a loan

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INTEREST RATE RISK

- Interest rate risk is the risk that the bank's assets and liabilities could change value when the interest rate changes.

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LIQUIDITY RISK

- Liquidity risk is the risk of insufficient liquidity for normal operating requirements, that is, the ability of the bank to meet its liabilities when they fall due.

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OTHER RISKS

- Operational risk
- Sovereign or political risks…

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