

Economics of Banking

Economics 301: Money and Banking

Goals and Learning Outcomes

1 / 17

- Goals:
 - Learn some banks functions and activities.
 - Learn about banks balance sheets.
 - Learn about different types of risks banks face and how they manage these risks.
- Learning Outcomes:
 - LO1: Understand and appreciate the importance of financial markets for the overall functioning of the economy.

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- Learning Outcomes:
 - LO1: Understand and appreciate the importance of financial markets for the overall functioning of the economy.

Reading

2 / 17

- Read Hubbard and O'Brien, Chapter 10.

Bank's Balance Sheets

3 / 17

- **Balance sheet:** A statement that shows an individual's or firm's position of assets and liabilities at a particular time.
- **Asset:** something of value that an individual or firm owns, such as a financial claim.
- **Liability:** a financial claim *on* an individual or firm.
- **Bank capital** or **shareholder's equity** is the value of the bank's assets over and above the value of its liabilities.

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3 / 17

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Bank Liabilities: Checkable Deposits

- **Checkable deposits:** Accounts which depositors can write checks. Also called *transaction deposits*.
- It is a liability, because it is money the bank owes to the depositors should they demand their funds back.
- From the perspective of an individual person or firm holding the checking account, checkable deposits are an asset.
- **Demand deposits:** Checking accounts that do not pay interest.
- **NOW (Negotiable Order of Withdrawal) accounts:** checkable deposits that pay interest.

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Bank Liabilities: Nontransaction Deposits

- **Nontransaction deposits:** interest bearing deposit accounts with restricted access to funds for the depositors.
- **Money market deposit accounts:** interest bearing accounts, depositors can write a limited number of checks from this account per month.
- **Saving accounts:** interest bearing accounts, typically have minimum balance or number of withdrawal requirements.
- **Time deposits or Certificates of deposit (CDs):** deposit accounts with specified maturity dates ranging from several months to several years.
 - Banks charge penalties for withdrawing funds prior to maturity date.
 - Large denomination CDs (over \$100,000) are *negotiable*, which means they can be liquidated in a secondary market prior to maturity.

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Bank Liabilities: Borrowing

- **Federal funds borrowing:** banks make literally overnight loans to each other.
 - Interest rate they charge is the **federal funds rate**. Currently about 0.08% (annual rate). Recent steady state value around 5%.
 - Has nothing to do with federal government funds.
- **Discount loans:** banks can borrow funds from the Federal Reserve, at the *discount window*.
 - Strangely enough, not at a discount. Current discount rate is 0.125%. Usually set very close to the federal funds rate.
- **Repurchase agreements:** banks sell something (usually treasuries) to another party, with an agreement to purchase it back, usually the next day.
 - Kind of like a pawn shop loan.
 - Banks usually borrow from large corporations through this channel.

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6 / 17

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6 / 17

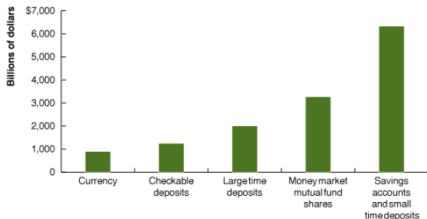
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Banking Trends

7 / 17



- Despite innovations for checkable deposits, checkable deposits are a shrinking fraction of bank's liabilities.
- Innovations in other interest-bearing assets have had a larger effect.

Bank Assets: Reserves

8 / 17

- **Reserves:** vault cash plus deposits with the Federal Reserve.
- **Vault cash:** cash on hand, including cash held in banks' vaults, cash held in ATMs, and deposits held with other banks.
- **Required reserves:** The Federal Reserve requires banks to hold a certain fraction of demand deposits and NOW deposits in reserves.
- **Required reserve ratio (RRR):** percentage of demand and NOW deposits the bank is required to keep on reserve.
 - For deposits between \$0 and \$11.5 million, $RRR = 0\%$.
 - For deposits in excess of \$11.5 million, and up to \$71.0 million, $RRR = 3\%$.
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- Limited amounts of municipal bonds.
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- Mortgage-backed securities. In 2010, made up 56% of bank securities held.

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Bank Assets: Loans

10 / 17

- Loans:
 - Largest category of banks' assets.
 - Illiquid.
 - Banks earn higher interest than with marketable securities.
- Types of loans:
 - Loans to businesses (or Commercial and Industrial (C&I) loans).
 - Consumer loans - loans to consumers to buy cars, furniture, other crap.
 - Real estate loans - residential mortgages.
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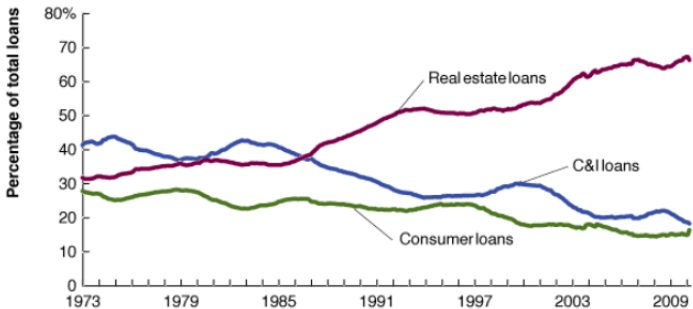
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Bank Assets: Loans

11 / 17



- Over last 40 years, loans to businesses have diminished in importance.
- Real estate loans now compose almost two-thirds of banks' total loans (versus one-third 40 years ago).

Other Assets

- Repossessed collateral, including real estate from borrowers who defaulted on their loans.
- Bank's physical assets, such as its own buildings, office furniture, and computer equipment.

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Working with Defaults

13 / 17

- **Write-downs** or **write-offs**: when a bank expects a loan will not be repaid, or only partially repaid, the bank reduces the value of the loan (asset) on its balance sheets or removes the value entirely.
- **Loan loss reserve**: banks set aside part of their capital (what is that?) to offset anticipated future write-offs.
 - When a bank sets aside money in its loan loss reserves, it decreases current profits.
 - When a borrower defaults, and the bank uses its loan loss reserves, it adds these funds back to its assets, and profits do not change.
 - It is a way of smoothing out the pain of defaults.

Working with Defaults

13 / 17

- **Write-downs** or **write-offs**: when a bank expects a loan will not be repaid, or only partially repaid, the bank reduces the value of the loan (asset) on its balance sheets or removes the value entirely.
- **Loan loss reserve**: banks set aside part of their capital (what is that?) to offset anticipated future write-offs.
 - When a bank sets aside money in its loan loss reserves, it decreases current profits.
 - When a borrower defaults, and the bank uses its loan loss reserves, it adds these funds back to its assets, and profits do not change.
 - It is a way of smoothing out the pain of defaults.

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Liquidity Risk

- **Liquidity risk:** the possibility the bank may not have reserves on hand to meet it's depositors needs.
- Ways to manage liquidity risk involves:
 - Keep excess reserves
 - Make federal funds loans with excess funds.
 - Make reverse repurchase agreements with other banks or corporations (agreements to buy with the promise to resell).
 - What are the problems with these solutions?

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Credit Risk

- **Credit risk:** risk that borrowers may default on their loans.
- Exacerbated by problems of *adverse selection* and *moral hazard*.
- **Diversification:** diversify across borrowers, regions, and industries.
- **Credit-risk analysis:** use of information about borrowers' employment, income, net worth, and credit scores to mindlessly determine loan eligibility and interest rate.
- **Relationship banking:** established long-term relationship between a bank and a borrower. Reduces asymmetric information.
- Collateral, credit rationing, restrictive covenants.

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Interest Rate Risk

- Interest rate risk: the effect a change in market interest rates has on bank's profits or bank capital.
- A change in interest rates affects the present value of banks' assets and liabilities.
- The impact depends on whether assets and liabilities are fixed rate or variable rate.
- Suppose a bank's assets are primarily fixed rate mortgages, and its liabilities are variable rate deposit accounts. What is the effect of an increase in interest rates on a bank's capital?

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Managing Interest Rate Risk

- **Gap analysis:** the gap is the difference between the dollar value of a bank's variable-rate assets and the dollar value of its variable-rate liabilities. Typically positive.
- **Duration gap:** difference between the average duration of a bank's assets and a bank's liabilities.
 - Most banks have a positive duration gap.
 - In this case, an increase in interest rates will have a larger effect on the present value bank's assets than on present value of bank's liabilities.
- **Adjustable-rate loans:** loans whose interest rates, and therefore payments, change before maturity.
- **Interest-rate swaps:** exchanges with other financial firms or corporations - payments of a fixed-rate loans received by the bank exchanged for payments of flexible-rate loans received by the other firm.

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