

Introduction to Money, Banking, and Financial Markets

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Introduction to Banking

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INTRODUCTION TO BANKING



What is a Bank?

A bank can be broadly defined in terms of:

- ✓ The economic functions it performs.
- ✓ The services it offers its customers.
- ✓ The legal basis for its existence.

- ❖ **Definition by Economic Function:** A bank is a financial institution that *received deposits, give loans, and manage assets*. They are involved in *transferring funds* from savers to borrowers (financial intermediation) and in paying for goods and services.
- ❖ **Definition by Services it Offers:** A bank is a financial intermediary that offers services such as *loans and deposits, and payment services*. A Banks may also provide other financial services such as *currency exchange, issue of securities and safe deposit boxes*. However, bank service menus are expanding rapidly, banks no longer limit their service offerings to traditional services but have increasingly become general financial-service providers.

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❖ **Definition by Legal Basis for its Existence:** A bank is a *financial institution licensed* to receive deposits, give loans, and manage assets. A bank is a *licensed financial institution* that makes a profit by taking people's deposits and lending that money at a profit.

The functions and services of banks are intertwined, and changing within the global financial system, acquiring some features of their competitors. The traditional functions and services:

Service or function	Revenue generated	Risk
Lending		
– Retail	Interest income, fees	Credit, Market
– Commercial	Interest income, fees	Credit, Market
– Mortgage	Interest income, fees	Credit, Market
– Syndicated	Trading, interest income, fees	Credit, Market
Credit cards	Interest income, fees	Credit, Operational
Project finance	Interest income, fees	Credit
Trade finance	Interest income, fees	Credit, Operational
Cash management		
– Processing	Fees	Operational
– Payments	Fees	Credit, Operational
Custodian	Fees	Credit, Operational
Private banking	Commission income, interest income, fees	Operational
Asset management	Fees, performance payments	Credit, Market, Operational
Capital markets		
– Investment banking	Fees	Credit, Market
– Corporate finance	Fees	Credit, Market
– Equities	Trading income, fees	Credit, Market
– Bonds	Trading income, interest income, fees	Credit, Market
– Foreign exchange	Trading income, fees	Credit, Market
– Derivatives	Trading income, fees	Credit, Market

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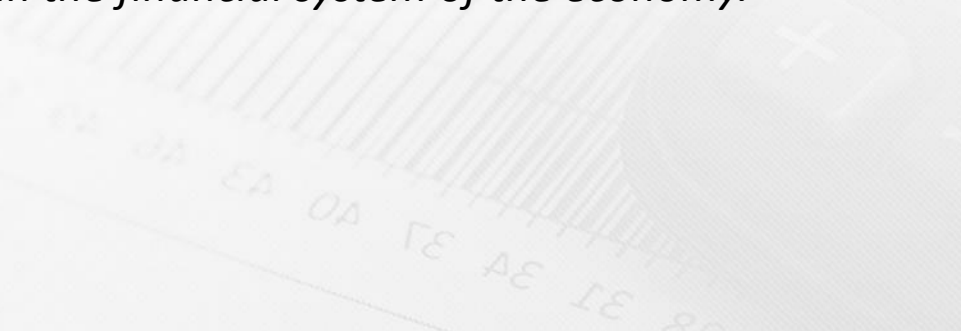


Banks are the principal source of credit and funds for millions of individuals, families, firms and for many units of government. Banks grant more installment loans to consumers (individuals and families) than any other financial-service provider.

Banks are also among the leading buyers of bonds and notes governments issue to finance public facilities.

Banks are among also the most important sources of short-term working capital for businesses and have become increasingly active in recent years in making long-term business loans to fund the purchase of new plant and equipment.

In many countries like Japan, and other civil law countries, banks hold more than half of all assets in the financial system of the economy.



INTRODUCTION TO BANKING



However, The United Kingdom's Financial Services and Markets Act of 2000 provide the following range of activities that banks can engage:

- Accepting deposits
- Issuing e-money (or digital money), i.e. electronic money used on the internet.
- Implementing or carrying out contracts of insurance as principal.
- Dealing in investments (as principal or agent)
- Managing investments
- Advising on investments
- Safeguarding and administering investments
- Arranging deals in investments and arranging regulated mortgage activities
- Advising on regulated mortgage contracts
- Entering into and administering a regulated mortgage contract
- Establishing and managing collective investment schemes (for example, investment funds and mutual funds)
- Establishing and managing pension schemes

INTRODUCTION TO BANKING

Because of the wide range of services that bank offers, there are many kinds of banks ranging from savings banks, investment banks, mortgage banks, merchant banks, universal banks, to mention but a few. Lets compare some of the various kinds of banks:

Money-Centered Banks vs. Community Banks: Money-center banks are industry leaders, spanning whole regions, nations, and continents, offering the widest possible menu of financial services, gobbling up smaller businesses, companies and facing tough competition from other giant financial firms around the globe. On the other hand, Community banks are usually much smaller and service local communities and towns, offering a significantly narrower but often more personalized menu of financial services to the public. Nowadays, community banks are declining in numbers, but they also are proving to be tough competitors in the local areas they serve.

Example: HSBC - Money-Centered Banks

Micro-finance banks - Community Banks

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Name of Banking-Type Firm	Definition or Description
Commercial banks	Sell deposits and make loans to businesses, individuals, and institutions
Money center banks	Largest commercial banks based in leading financial centers
Community banks	Smaller, locally focused commercial and savings banks
Savings banks	Attract savings deposits and make loans to individuals and families
Cooperative banks	Help farmers, ranchers, and consumers acquire goods and services
Mortgage banks	Provide mortgage loans on new homes but do not sell deposits
Investment banks	Underwrite issues of new securities on behalf of their corporate customers
Merchant banks	Supply both debt and equity capital to businesses
Industrial banks	State-chartered loan companies owned by other corporations that provide credit and receive deposits
International banks	Commercial banks present in more than one nation
Wholesale banks	Larger commercial banks serving corporations and governments
Retail banks	Smaller banks serving primarily households and small businesses
Limited-purpose banks	Offer a narrow menu of services, such as credit card companies and subprime lenders
Bankers' banks	Supply services (e.g., check clearing and security trading) to banks
Minority banks	Focus primarily on customers belonging to minority groups
National banks	Function under a federal charter through the Comptroller of the Currency in the United States
State banks	Function under charters issued by banking commissions in various states
Insured banks	Maintain deposits backed by federal deposit insurance plans (e.g., the FDIC)
Member banks	Belong to the Federal Reserve System
Affiliated banks	Wholly or partially owned by a holding company
Virtual banks	Offer their services only over the Internet
Fringe banks	Offer payday and title loans, cash checks, or operate as pawn shops and rent-to-own firms
Universal banks	Offer virtually all financial services available in today's marketplace

INTRODUCTION TO BANKING



For many centuries banks were way in front of other financial-service institutions in supplying savings and investment services, payment and risk protection services, liquidity, and loans. However in recent years, banking's financial market share frequently has fallen as other financial institutions have moved into the front lines.

Nonbank financial intermediates have also start issuing loans and other bank related financial services. Among the leading competitors with banks in financial-service include nonbank financial-service institutions as:

- **Savings associations:** These are financial institutions that specializes in selling savings deposits and granting home mortgage loans and other forms of household credit to individuals and families.
- **Credit unions:** This is a nonprofit financial institution that collect deposits from its members and issue loans to their members.
- **Fringe banks:** These are small financial institutions that Include payday lenders, pawn shops, and cheque-cashing outlets, offering small loans bearing high risk and high interest rates to cover the immediate financial needs of cash for individuals and families.

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- **Money market funds:** These financial institutions collect liquid funds from individuals and institutions and invest these monies in quality securities of short duration.
- **Mutual funds:** These are financial intermediaries that sell shares to the public representing an interest in a professionally managed pool of stocks, bonds, and other securities.
- **Hedge funds:** These are also financial intermediaries that sell shares in a pool of assets mainly to upscale investors that typically include many different kinds of assets including commodities, real estate, loans to new and ailing companies, and other risky assets.
- **Security brokers and dealers:** These are financial intermediaries that buy and sell securities on behalf of their customers and for their own accounts.
- **Finance companies:** These companies offer loans to commercial enterprises such as auto and appliance dealers and to individuals and families using funds borrowed in the open market or from other financial institutions.

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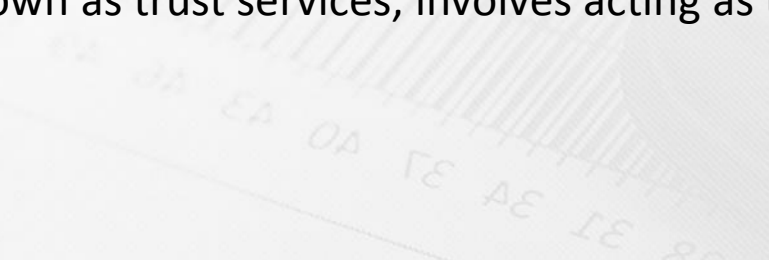
- **Financial holding companies (FHCs):** These are big conglomerates that often include credit card companies, insurance and finance companies, and security broker/dealer firms operating under one corporate umbrella. Example is GE Capital
- **Life and property/casualty insurance companies:** These firms provide a financial protection against risks to persons or property and manage the pension plans of businesses and the retirement funds of individuals.

Therefore, Financial intermediaries like banks and their closest-competitors, are financial-services providers, such services include the basic services of Issuing Loans, Accepting Deposits, and other services briefly explained below:

- **Currency Exchanges:** This is one of the first services that bank offers, a bank can trade one form of currency (such as dollars) for another (such as Dinar) in return for a service fee. Such exchanges have been important to travelers over the centuries, because the traveler's survival and comfort often depended on gaining access to local funds.


INTRODUCTION TO BANKING



- **Discounting Commercial Notes:** Local merchants can discount their debts (accounts receivable) to banks or factoring houses, in order to raise cash quickly.
 - **Safekeeping of Valuables and Certification of Value:** Gold and other valuables owned by bank customers can be secure inside the bank vaults, thus reassuring customers of their safekeeping.
 - **Supporting Government Activities with Credit:** Because banks have the ability to mobilize large amounts of funds, frequently banks were chartered under government provisions to purchase government bonds with a portion of the deposits they received.
 - **Offering Trust Services:** For many years banks and a few of their competitors such as insurance and trust companies have managed the financial affairs and property of individuals and business firms in return for a fee. This property management function, known as trust services, involves acting as trustees for wills.
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INTRODUCTION TO BANKING



- **Financial Advising:** Customers have long asked financial institutions for advice, particularly when it comes to the use of credit and the saving or investing of funds. Many service providers today offer a wide range of financial advisory services, from helping to prepare financial plans for individuals to consulting about marketing opportunities at home and abroad for businesses.
 - **Managing Cash:** One of the most prominent new services that financial institutions nowadays renders is cash management services, in which a financial intermediary agrees to handle cash collections and disbursements for a business firm and to invest any temporary cash surpluses in interest-bearing assets until cash is needed to pay bills.
 - **Offering Equipment Leasing:** Many banks and finance companies have leasing offers to their business customers. These are the option to purchase equipment through a lease arrangement in which the lending institution buys the equipment and rents it to the customer.
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INTRODUCTION TO BANKING



- **Making Venture Capital Loans:** Increasingly, banks, security dealers, and other financial conglomerates have become active in financing the start-up costs of new companies. Because of the added risk involved, this is generally done through a separate venture capital firm that raises money from investors to support young businesses in the hope of turning exceptional profits.
- **Selling Insurance Policies:** Banking and Insurance industries compete aggressively with each other, converging and pursuing cross-industry mergers, and acquisitions.
- **Selling and Managing Pensions and Retirement Plans:** Banks, trust departments, mutual funds, and insurance companies are active in managing the retirement plans most businesses make available to their employees. This involves investing incoming funds and dispensing payments to qualified recipients who have reached retirement or become disabled.

INTRODUCTION TO BANKING




- **Dealing in Securities: Offering Security Brokerage and Investment Banking Services:** One of the most popular service targets in recent years, particularly in the developed and emerging countries is dealing in securities, executing buy and sell orders for security trading customers (referred to as security brokerage services), and marketing new securities to raise funds for corporations and other institutions (referred to as security underwriting or investment banking services).
- **Offering Mutual Funds, Annuities, and Other Investment Products:** Mutual fund investments and annuities offer the prospect of higher yields than the returns, often available on conventional bank deposits and are among the most demanded investment products. However, these product line also tend to carry more risk than bank deposits do, which are often protected by insurance.

Annuities consist of long-term savings plans that promise the payment of a stream of income to the annuity holder beginning on a designated future date (e.g., at retirement). In contrast, mutual funds are professionally managed investment programs that acquire stocks, bonds, and other assets that appear to "fit" the funds announced goals.

INTRODUCTION TO BANKING



- **Offering Merchant Banking Services:** These consist of the temporary purchase of a corporate stock to aid the launching of a new business venture or to support the expansion of an existing company. Hence, a merchant banker becomes a temporary stockholder and bears the risk that the stock purchased may decline in value.
 - **Offering Risk Management and Hedging Services:** Nowadays, there are fundamental changes going on in the banking sector with larger banks (such as JP Morgan Chase) moving away from a traditionally heavy emphasis on deposit-taking and loan-making toward risk intermediation. Banks now provide their customers with financial tools to combat risk exposure in return for substantial fees. The largest banks around the globe now dominate the risk-hedging field, either acting as dealers (i.e., "market makers") in arranging for risk protection for customers from third parties or directly selling their customers the bank's own risk-protection services.
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Why Study Banking and Financial Institutions



Without banks, financial markets would not be able to move funds from people who save to people who have productive investment opportunities. Banks have a significant effects on the performance of the economy as a whole.

The financial system is complex, comprising many different types of private sector financial institutions, including banks, insurance companies, mutual funds, finance companies, and investment banks, all of which are heavily regulated by the government.

Question to revise your knowledge from the introduction to banking course:

Why are financial intermediaries so crucial to well-functioning financial markets?



Why Study Money and Monetary Policies



What is money?

Money, also referred to as the money supply, is defined as anything that is generally accepted in payment for goods or services or in the repayment of debts.

Money is linked to changes in economic variables that affect all of us and are important to the health of the economy.

To understand monetary policy, its effect on banks, the role of money in the economy and the relationship between money and economic success, it is important to know the followings:

Aggregate Output: This is the total production of good and services in an economy.

Business Cycle: This is the upward and downward movement of aggregate output produced in the economy. Business cycles affect all of us in immediate and important ways. When output is rising, for example, it is easier to find a good job; when output is falling, finding a good job might be difficult. Money plays an important role in generating business cycles

Why Study Money and Monetary Policies

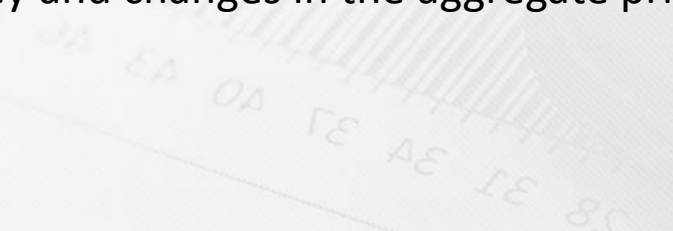


Recession: This is a period when aggregate output is declining. Every recession since the beginning of the twentieth century has been preceded by a decline in the rate of money growth, indicating that changes in money might also be a driving force behind business cycle fluctuations. However, not every decline in the rate of money growth is followed by a recession.

Monetary Theory: This is the theory that relates changes in the quantity of money to changes in aggregate economic activity and the price level.

Aggregate Price Level: This is the average price of goods and services in an economy.

❑ **Money and Inflation:** There is a positive association between inflation and the growth rate of the money supply. To control inflation we have to know the role of money in creating inflation by studying in detail the relationship between changes in the quantity of money and changes in the aggregate price level.




Why Study Money and Monetary Policies



- ❑ **Money and Interest Rates:** Money plays an important role in interest-rate fluctuations, which are of great concern to businesses and consumers. Interest is the key source of revenue for banks and other financial institutions. Therefore any changes in interest rate affects not only banks, but the financial system in general.
- ❑ **Monetary Policy:** Monetary policy in brief, is the management of the economy's money supply and interest rates. Because money can affect many economic variables that are important to the wellbeing of our economy, politicians and policymakers throughout the world care about the conduct of monetary policy. The organization responsible for the conduct of a nation's monetary policy is the central bank.

Therefore it is clear that the study of money and monetary policies are very important to the performance of financial markets, financial intermediaries, the financial system and the economy as a whole.



Why Study Financial Markets

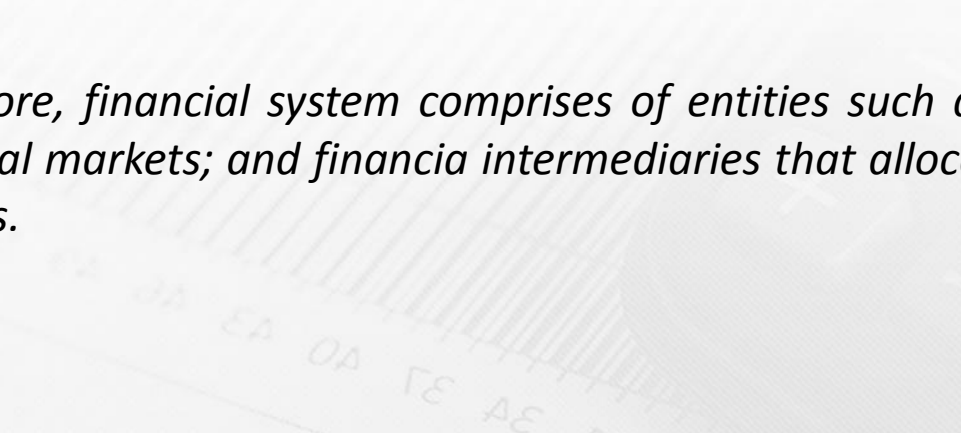


A financial market is a market in which funds are transferred from people who have an excess of available funds to people who have a shortage. Financial markets such as bond and stock markets are crucial to promoting greater economic efficiency by channeling funds from people who do not have a productive use for them to those who do.

Well-functioning financial markets are a key factor in producing high economic growth, and poorly performing financial markets are one reason that many countries in the world remain desperately poor.

Activities in financial markets also have direct effects on personal wealth, the behavior of businesses and consumers, and the cyclical performance of the economy.

Therefore, financial system comprises of entities such as individuals, household and firms; financial markets; and financial intermediaries that allocate and distribute funds from and to entities.




Key Trends Affecting Banks and other Financial Services



As stated before, banks and many of their financial service competitors are currently undergoing sweeping changes in function and form. In fact, the changes affecting the financial-services business today are so important that many industry analysts refer to these trends as a **revolution**.

The key trends reshaping banking and financial services today include:

- ❖ **Service Proliferation:** Leading financial firms have been expanding the menu of services they offer to their customers. This trend toward service proliferation has accelerated in recent years under the pressure of competition from other financial firms, more knowledgeable and demanding customers, and shifting technology. The new services have opened up new sources of revenue known as **service fees**, which are likely to continue to grow relative to more traditional sources of financial-service revenue such as interest earned on loans.
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Key Trends Affecting Banks and other Financial Services




- ❖ **Rising Competition:** The level and intensity of competition in the financial-services field have grown as financial institutions have proliferated their service offerings. For example, the local bank offering business and consumer credit faces direct competition for these services today from other banks, thrift institutions, securities firms, finance companies, and insurance companies and agencies.
- ❖ **Government Deregulation and then Reregulation:** Government deregulation refers to the loosening of government control and lessening of strict laws that hinders ease of business. Rising competition and the proliferation of financial services have been spurred on by government deregulation—a loosening of government control-of the financial services industry that began in the final decades of the 20th century and soon spread around the globe.

However, a new regulatory trend known as **reregulation**, which means the tightening of government rules for the financial sector was part of the concessional response to the near-collapse of the economy during the great 2007-2009 recession. Governments around the globe began to restrict the taking on of new financial services and new markets and focus more sharply on the dangers, the measurement, and tracking of systemic risk across the whole financial system.

Key Trends Affecting Banks and other Financial Services



- ❖ **Crisis, Reform, and Change in Banking and Financial Services:** The global financial crisis of 2007-2009 led to changes in the financial sector by multiple forces, from economics to politics and everything in between. Obvious issues are the issues of corporate governance, application of IFRS and etc.
 - ❖ **An Increasingly Interest-Sensitive Mix of Funds:** Financial-service managers have discovered that they are facing a better-educated more interest-sensitive customer today whose loyalty can more easily be lured away by competitors. Financial-service provider now strive to be more competitive and more sensitive to changing public preferences with regard to how savings are allocated.
 - ❖ **Technological Change and Automation:** Banks and many of their most serious competitors have been faced with higher operating costs in recent years and, therefore, have turned increasingly to automation and the installation of sophisticated electronic systems to replace older, labor-based production and delivery systems.
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Key Trends Affecting Banks and other Financial Services

- ❖ **Consolidation and Geographic Expansion:** Making efficient use of automation and other technological innovations requires a high volume of sales. So financial-service providers have had to expand their customer base through geographic expansion, reaching into new and more distant markets and increasing the number of service units sold in those expanding markets.
- ❖ **Convergence:** Convergence refers to the movement of businesses across industry lines so that a firm formerly offering perhaps one or two product line ventures into other product lines to broaden its sales base. Service proliferation and greater competitive rivalry among financial firms have led to a powerful trend of convergence.
- ❖ **Globalization:** The geographic expansion and consolidation of financial-service units have reached well beyond the boundaries of a single nation to encompass a global trend called **globalization**. The largest financial firms in the world compete with each other for business on every continent. For example, Germany's Deutsche Bank, the UK's HSBC, the U.S.'s JP Morgan Chase, etc.



Any Question?

THANK YOU

