Introductions to Banking

By

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01 An introduction to banking

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03 The role of Banks in the Economy

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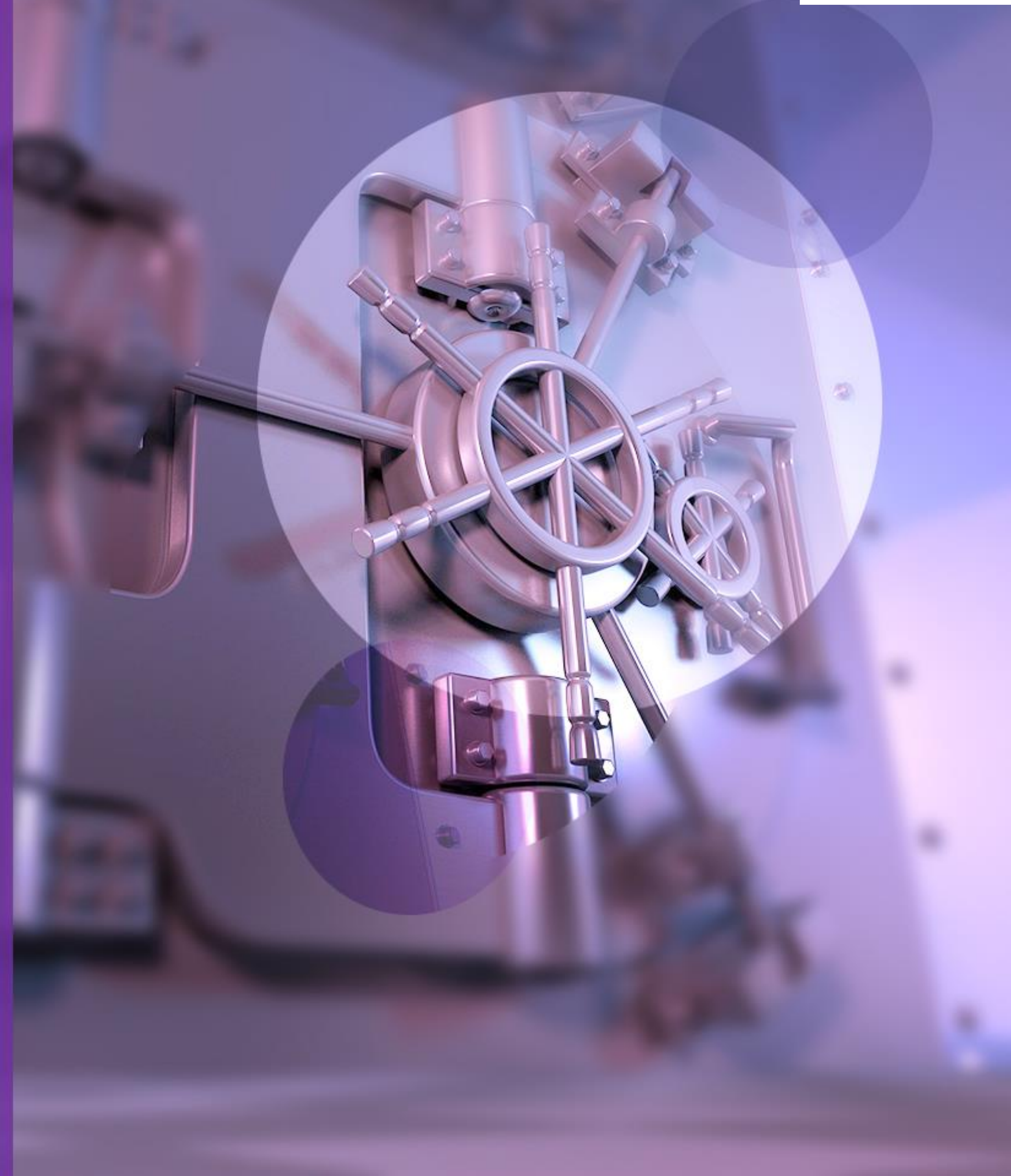
05 Theories of Financial Intermediation

06 The Benefits of Financial Intermediation



AN INTRODUCTION TO BANKING

What is a Bank?

- ❖ A bank is a financial institution licensed to receive deposits, give loans, and manage assets. A Banks may also provide other financial services such as currency exchange, issue of securities and safe deposit boxes. In another words, A bank is a financial intermediary that offers loans and deposits, and payment services.

- ❖ A bank is a financial institution that makes a profit by taking people's deposits and lending that money at a profit. In other words, the institution charges more for its loans than it pays on deposits. In fact, banks pay no interest on some types of accounts, such as checking accounts or current accounts.

What is Banking?

- ❖ Banking is defined as the business activity of accepting and safeguarding money owned by other individuals and entities, and then lending out this money in order to conduct economic activities such as making profit or simply covering operating expenses.

AN INTRODUCTION TO BANKING

Are all financial institutions that accept deposit and lend money bank?

- **Credit Union:** A Credit union Just like banks, provide routine financial services for their clients who are generally called members. These services include deposit, withdrawal, and basic credit services.

- **Differences Between A Credit Union and A Bank:**
  - ✓ While a bank is a profit-driven entity, a credit union is a nonprofit organization traditionally run by volunteers.
  - ✓ Credit unions are created, owned, and operated by participants. On the other hand, the shareholders of banks are generally different from its managers.
  - ✓ Credit unions are generally tax exempted, while banks pay tax to the government on its profit and other relevant taxes.
  - ✓ Members of credit unions purchases their shares in the coop, and that money is pooled together to provide a credit union's credit services. On the other hand, banks lend the deposits entrusted to it as loans and credits.

What does Banks do?

Banks today offer many services to either individuals or companies.

AN INTRODUCTION TO BANKING

Banking operations encompass a wide range of activities, all of which contribute to the asset and liability profile of a bank.

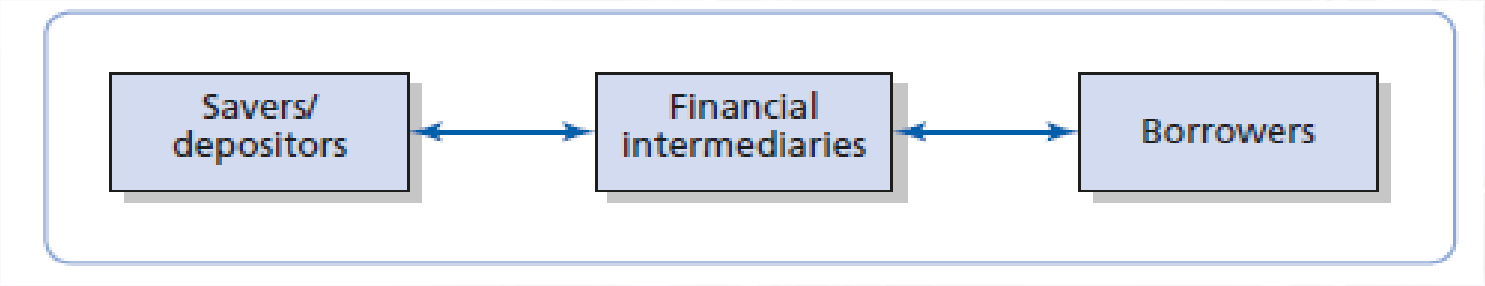
Service or function	Revenue generated	Risk
Lending		
– Retail	Interest income, fees	Credit, Market
– Commercial	Interest income, fees	Credit, Market
– Mortgage	Interest income, fees	Credit, Market
– Syndicated	Trading, interest income, fees	Credit, Market
Credit cards	Interest income, fees	Credit, Operational
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

THE NATURE OF FINANCIAL INTERMEDIATION

To understand why we need banks and why we need to study banking, it is necessary to understand the role of financial intermediaries in an economy.

- Financial intermediaries' main role is to provide a mechanism by which funds are transferred and allocated to their most productive opportunities.

- A banks act as intermediaries between borrowers and savers.



- In doing so, bank channel funds from savers to borrowers, thereby increasing economic efficiency by promoting a better allocation of resources.

THE NATURE OF FINANCIAL INTERMEDIATION

Why do we borrow?

Borrowing occurs whenever an economic unit's (individuals, households, companies, government bodies, etc.) total expenditure exceeds its total receipts. Therefore borrowers are generally referred to as "***deficit units"*** and lenders are known as "***surplus units"***.

What is Financial claim?

A financial claims are also known as "***Collateral Assets" or "Collateral Securities***". A financial claim carries an obligation on the borrower to pay interest periodically and to redeem the claim at a stated value in one of 3 ways:

- ✓ On demand;
- ✓ After giving a stated period of notice;
- ✓ On a definite date or within a range of dates.

Financial claims can take the form of any financial asset, such as money, bank deposit accounts, bonds, shares, loans, life insurance policies, etc.

THE NATURE OF FINANCIAL INTERMEDIATION

The lender of funds holds the borrower's financial claim and is said to hold a ***financial asset***. The issuer of the claim (borrower) is said to have a ***financial liability***.

Why do we need bank (Intermediary) for borrowing?

- The difficulty and expense of matching the complex needs of individual borrowers and lenders.
- The incompatibility of the financial needs of borrowers and lenders.
- Lenders are looking for safety and liquidity, which bank has.

Loan at Default: A loan becomes at default when the borrower could not meet the repayment obligations.

THE NATURE OF FINANCIAL INTERMEDIATION

Lenders' requirements and aims

- **The minimisation of risk**:This includes the minimization of the risk of default and the risk of assets dropping in value.
- **The minimization of cost**: Lenders aim to minimize their costs.
- **Liquidity**: An asset is said to be liquid if it can be quickly and easily converted into cash without loss of capital value. One reason for this is the lack of knowledge of future events, which results in lenders preferring short-term rather than long-term lending.

Borrowers' requirements and aims

- Funds at a particular specified date.
- Funds for a specific period of time, preferably long-term.
- Funds at the lowest possible cost.

THE NATURE OF FINANCIAL INTERMEDIATION

Therefore, Financial intermediaries like banks can bridge the gap between borrowers and lenders, and reconcile their often incompatible needs and objectives.

Financial intermediaries also helps to minimize the costs associated with direct lending:

Transaction costs: Transaction costs relate to the costs of searching for a counterparty to a financial transaction. This include the costs of obtaining information about them, the costs of negotiating the contract, the costs of monitoring the borrowers, and the eventual enforcements costs if the loan defaulted.

Information asymmetries: In addition to transaction costs, lenders are faced with the problems caused by asymmetric information. These problems arise because one party has better information than the counterparty. In this context, the borrower has better information about the investment (in terms of risk and returns of the project) than the lender

THE ROLE OF BANKS IN THE ECONOMY

The main function of banks is to collect funds (deposits) from units in surplus and lend funds (loans) to units in deficit. But deposits typically have the characteristics of being ***small-size, low-risk and high-liquidity***. However, loans are ***of larger size, higher risk and illiquid***.

Therefore, banks bridge the gap between the needs of lenders and borrowers by performing a transformation function:

Size transformation:Banks collect funds from savers in the form of small size deposits and repackage them into larger-size loans.

Maturity transformation: Banks transform funds lent for a short period of time into medium- and long-term loans. Example, they convert deposits of people money that can be demanded for withdrawal by the depositor at any period of time, into a into 20-year residential mortgages.

THE ROLE OF BANKS IN THE ECONOMY

Therefore, banks are '*borrowing short and lending long*' and this process creates a mismatch in their assets and liabilities.

This mismatch can create problems in terms of ***liquidity risk***, which is the risk of not having enough money to meet its obligation of satisfying its customers.

Risk transformation: Individual borrowers carry a risk of default (known as credit risk), that is the risk that they might not be able to repay the amount of money they borrowed. Savers wish to minimize risk and prefer their money to be safe. Banks transform these risks by been able to minimize the risk of individual loans through the diversification of their investments, pooling risks, screening and monitoring borrowers.

At the same time, it holds capital and reserves as a ***buffer*** for unexpected losses and to satisfy any sudden need of withdrawals by its customers.

INFORMATION ECONOMIES

Banks are also managers of information. Because of their good information management skills they are able to exercise one of their main features which is; the reduction of transaction costs by exploiting both the economics of scale and scope.

Banks traditionally differ from other financial intermediaries for two main reasons:

- ✓ Bank liabilities (i.e. deposits) are accepted as a means of exchange. And
- ✓ Banks are the only intermediaries that can vary the level of deposits and can create and destroy credit.

Economies of scale and economies of scope: Financial intermediaries reduce transaction, information and search costs mainly through economies of scale by:

- ➢ Increasing the volume of transactions which leads to the decrease in cost per unit of transactions.

INFORMATION ECONOMIES

- Focusing on growing in size

- Drawing standardized contracts and monitor customers so that they enforce these contracts

- Training high-quality staff to assist in the process of finding and monitoring suitable deficit units (borrowers), because It is difficult, time-consuming and costly for an individual to do so.

- Pooling or aggregating individual risks so that in normal circumstances, surplus units will be depositing money as deficit units make withdrawals.

On the other hand, ***economies of scope*** refers to a situation where the joint costs of producing two complementary outputs are less than the combined costs of producing the two outputs separately. for example, the economies derived from the joint supply of banking and insurance services. A bank might sell both mortgages and life insurance policies that go with them, therefore creating cross-selling opportunities for the bank

INFORMATION ECONOMIES

Asymmetric information: Information is at the heart of all financial transactions and contracts. Three are three relevant problems relating to information:

- ✓ Not everyone has the same information.
- ✓ Everyone has less than perfect information
- ✓ Some parties to a transaction have 'inside' information that is not made available to both sides of the transaction

Cases of any of these or their combination is refers as ***information asymmetry***. Asymmetric information can make it difficult for two parties to do business together, and this is why regulations are introduced to help reduce mismatches in information.

Information asymmetries, or the imperfect distribution of information among parties, can generate many big problems.

INFORMATION ECONOMIES

One general solution to information problems is for those involved in financial transactions to invest in information, however, this is not a costless activity.

Relationship banking: When banks invest in developing close and long-term relationships with their customers, such relations improve the information flow between the bank and the borrower and thus are beneficial to both parties.

This is called "***a relational contract***". Relational contracts are informal agreements between the bank and the borrowers sustained by the value of future relationships.

If the customer has a history with the bank, for example, they have borrowed previously from the bank over a long period of time, then the bank's screening and monitoring costs will be much lower. Meanwhile, borrowers will find it easier to get future loans at relatively low rates of interest.

THEORIES OF FINANCIAL INTERMEDIATION

There are five theories that explain why financial intermediation (banking) exists:

1. **Delegated Monitoring**
2. **Information Production**
3. **Liquidity Transformation**
4. **consumption Smoothing**
5. **Commitment Mechanisms**

THEORIES OF FINANCIAL INTERMEDIATION

Delegated Monitoring: One of the main theories that put forward as an explanation for the existence of banking relates to the role of banks as *monitors* of borrowers. Banks have expertise and economies of scale in processing information on the risks of borrowers and as depositors would find it costly to undertake this activity, they delegate responsibility to the banks.

Information production. Banks have economies of scale, and other expertise in processing information relating to borrowers, this information may be obtained upon first contact with borrowers but in reality is more likely to be learned over time through repeated dealings with the borrower. As banks build up this information they become ***experts in processing this information***.

Therefore, banks have an information advantage and depositors are willing to place funds with a bank knowing that these will be directed to the appropriate borrowers without the depositor having to incur information costs.

THEORIES OF FINANCIAL INTERMEDIATION

Liquidity transformation: Banks' deposits can be viewed as contracts offering high liquidity and low risk that are held on the liabilities side of a bank's balance sheet. These are financed by relatively illiquid and higher risk assets (e.g. loans) on the assets side of the bank's balance sheet. Banks also hold liabilities and assets of different liquidity features on both sides of their balance sheet through diversification of their portfolios.

Consumption smoothing: Banks perform a major function as consumption smoothers. Economic agents have uncertain preferences about their expenditure and this creates a demand for liquid assets. Financial intermediaries like banks provide these assets via lending and thus, this helps smooth consumption patterns for individuals. As such, banks are institutions that enable economic agent to smooth consumption by offering insurance against shocks to a consumer's consumption path.

Commitment mechanisms: To control the risk-taking propensity of banks, demand deposits have developed because changes in the supply and demand of these instruments will be reflected in financing costs and this disciplines or commits banks to behave prudently, i.e. this ensure that banks hold sufficient liquidity and capital resources.

THE BENEFITS OF FINANCIAL INTERMEDIATION

A wide range of financial institutions are engaged in financial intermediation, including banks , insurance and pension firms, securities houses and others. An important distinguishing characteristic of financial intermediation is that financial assets and liabilities in the process of the intermediation are created.

The significance of financial intermediation within the financial system is best appreciated in terms of the benefits that it generates. These benefits accrue to:

- ✓ Ultimate lenders (surplus units),
- ✓ Ultimate borrowers (deficit units) and
- ✓ Society as a whole.

THE BENEFITS OF FINANCIAL INTERMEDIATION

The benefits to ultimate lenders (surplus units) are:

- Greater liquidity is generally achieved by lending to a financial intermediary rather than directly to an ultimate borrower.
- Less risk is involved, due to the pooling of risk inherent in financial intermediation, the improved risk assessment that intermediaries are able to undertake and the portfolio diversification that can be frequently achieved.
- Marketable securities may be issued as the counterpart to deposits with a financial intermediary. For example, a certificate of deposit (CD) is a type of time deposit where the bank issues a certificate that a deposit has been made.
- Transaction costs associated with the lending process are likely to be reduced significantly especially where straightforward deposit facilities are utilized.
- The lending decision is more simplified.

THE BENEFITS OF FINANCIAL INTERMEDIATION

The benefits to ultimate borrowers (deficit units) are:

- Loans will generally be available for a longer time period from financial intermediaries than from the ultimate lenders.
- Financial intermediaries will generally be prepared to grant loans of larger amounts than will ultimate lenders.
- Using financial intermediaries will generally involve lower transaction costs than would be incurred if borrowers had to approach ultimate lenders directly.
- The interest rate will generally be lower when borrowing from financial intermediaries, compared with borrowing directly from ultimate lenders.
- When borrowing from financial intermediaries, there is a greater likelihood that loans will be available when required.

THE BENEFITS OF FINANCIAL INTERMEDIATION

The benefits to society as a whole are:

- Financial intermediaries like bank leads to a more efficient utilization of funds within an economy, since the evaluation of lending opportunities will be improved

- They also cause a higher level of borrowing and lending to be undertaken, due to the lower risks and costs associated with lending from financial intermediaries.

- They also cause an improvement in the availability of funds to higher-risk ventures, due to the capability of financial intermediaries to absorb such risk. High-risk ventures are widely considered to be important for creating the basis of future prosperity for an economy.

Any Question?

THANK YOU

Questions Bank

1. Differentiate between Bank and Banking
2. Explain 5 differences between a bank and a credit union
3. What is a financial claim?
4. Explain at least three 3 lenders requirement and 3 borrowers requirement to borrow.
5. What is Transaction cost
6. What is information asymmetry
7. List and explain the three (3) transformation functions of a bank
8. Differentiate between economics of scale and economics of scope
9. Explain Delegated Monitoring Theory of financial intermediation
10. Explain Information production theory of financial intermediation
11. Differentiate between Liquidity transformation theory and Consumption smoothing theory
12. List five (5) benefit of Financial Intermediation to a Lender.
13. List five (5) benefit of Financial Intermediation to a borrower.
14. List Three (3) benefit of Financial Intermediation to the society.

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