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Readings in Finance and Banking

القراءات المالية

المرحلة الاولى

أعداد

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Chapter ١: Financial System

The Fundamental Concept of Financial System:

The financial system comprises a set of sub-systems of financial institutions, financial markets, financial instruments and services which help formation of capital. It is providing a mechanism by which savings are transformed into investment.

Functions of financial system:

Financial systems perform the essential economic function of channeling funds from units who have saved surplus funds to units who have a shortage of funds. The units who have saved can lend funds: they are known as lender-savers. The units with a shortage of funds must borrow funds to finance their spending: they are the borrower-spenders. The most important lender-savers are usually households; while the typical borrower-spenders are firms and the government.

Another important function of a financial system is the monetary function. The introduction of money into the economy enables savers and spenders to separate the act of sale from the act of purchase and allows them to overcome the main problem of barter. The financial system provides a variety of payment mechanisms e.g. cheques, debit cards and credit cards to enable one party to pay another. Financial systems also provide mechanisms for risk to be transferred. For example, insurance contracts allow a party such as a firm or household to transfer the risk of loss of wealth due to theft or fire to another party such as an insurance company.

The Basic Elements of Well-Functioning Financial System

١. **A strong legal and regulatory environment:** Since finance is based on contracts, strong legal and regulatory systems that can enforce laws and protect the rights of the investors.

٢. **Stable money:** It serves as a medium of exchange; a store of value (a reserve of future purchasing power), and standard of value (unit of account) for all the goods and services we might wish to trade in.

٣. **Sound public finances and public debt management:** Includes setting and controlling public expenditure priorities and raising revenues adequate to fund them efficiently.

٤. **A central bank:** A central bank supervises and regulates the operations of the banking system. It acts as a banker to the banks, banker to the government, manager of public debt and foreign exchange.

٥. **A sound banking system:** A good financial system should have many banks with domestic and international operations. They perform diverse key functions such as operating payments system and foreign exchange market.

٦. **An information system:** All participants in a financial system require information. A sound financial system can develop only when proper disclosure practices and networking of information systems are adopted.

٧. **An efficient securities market:** Efficient securities markets promote economic growth by mobilizing and deploying funds into productive uses, enhancing liquidity, and attracting foreign investment.

Chapter ٢: The Banks

Concept of Banking

Banks are financial institutions that accept deposits and make loans. Included under the term banks are firms such as commercial banks, savings and loan associations, mutual savings banks, and credit unions. Banks are the financial intermediaries that the average person interacts with most frequently. A person who needs a loan to buy a house or a car usually obtains it from a local bank. Most people keep a large proportion of their financial wealth in banks in the form of checking accounts, savings accounts, or other types of bank deposits.

Why do Banks Exist?

A. Size transformation:

Investors (borrowers) usually need large quantity of funds for doing business exceed the capacity of one or few number of savers. Thus, the bank can collect a number of small savings (deposits) parcel them together and lend out a large sum to a borrower.

B. Maturity transformation:

The lender (saver) usually wants to be able to have access to his funds in the event of emergency. However, the borrower wishes to have security of his funds over the life of project or investment. Thus, the bank can fulfill this gap by offering short-term deposits and making loans for a longer period. The extreme example of this process is housing loans, which have a typically ٢٥ years, whereas the bank will support this loan by a variety of much shorter deposits.

C. **Risk transformation:**

The lender will prefer assets with a low risk whereas borrowers will use borrowed funds to engage in risky operations. In order to do this borrower are willing to pay a higher charge than that necessary to remunerate (reward) lenders where risk is low.

Hence, how do banks deal with risk of default of their borrowers? The banks can reduce the default risks by diversifying their portfolio of loans in this way; banks are able to reduce the impact of any one failure (a borrower). Banks also obtain collateral from their borrowers, which also helps to reduce the risk of an individual loan since the cost of default will be borne by the borrower up to value of the collateral. Banks can also screen applications for loans and monitor the conduct of the borrower. Banks also hold sufficient capital to meet unexpected losses of loans. By all of these means the banks can offer relatively riskless deposits while making risky loans.

D. **Cost reduction:**

The transactions cost between the lender and borrower (transferring fund from surplus to deficit units) is high in the case of absent of a bank vice versa.

Types of Banks

١- Central bank:

Central bank is the government bank that manages, regulates, and protects both the money supply and the banks themselves. Central banks serve as the government’s banker. Central banks have many functions, such as **issue and mange currency**, **implement of monetary policy and exchange rate policy**, **storing and managing the country’s gold reserves**, **create and improve an effective payments system and supervises and regulates the banking sector, including issuing licenses and permits.** In the United States, the Federal Reserve System performs the central banking function. Although the Federal Reserve is technically owned by the banks themselves, the Board of Governors is appointed by the President with consent of the Senate. The President also selects the powerful chair of the Federal Reserve.

٢- Commercial bank:

Commercial banks are banking institutions that accept deposits and grant short-term loans and advances to their customers. In addition to giving short-term loans, commercial banks also give medium-term and long-term loans to business enterprise. Commercial banks do about ٦٠ percent of the deposit and loan business in the United States, and provide familiar services such as checking and saving accounts, credit cards, investment services, and others. Historically, commercial banks offered their services only to business. Today, commercial banks seek the business of any worth customer.

Types of Commercial Banks: commercial banks have many types such as public sector banks, private sector banks, etc.

- **Public sector banks:** These are banks owned entirely by the government. Example of the public sector banks in Iraq are Rafidain Bank and AL-Rasheed Bank
- **Private sectors banks:** The majority of share capital of these banks is held by private individuals. These banks are registered as companies with limited liability. For example, Baghdad Bank, Economic Bank, etc.

٣- Foreign banks:

These banks are registered and have their headquarters in a foreign country but operate their branches in our country.

٤- Specialized banks:

These are some banks, which cater the requirements and provide overall support for setting up business in specific areas of activity. They engage themselves in some specific area or activity and thus are called specialized banks. For example, the Industrial Bank which provides long-term loans for developing the projects in the industrial sector. Agricultural Bank and Real Estate Bank are other examples.

Functions of Banks

Banks facilitate the transfer of funds from those who have funds (savers) to those who need funds (borrowers). In reality, however, they do far more than simply transfer money and securities between borrowers and savers. They exactly manufacture a variety of financial products, including mortgages, automobile loans; such products allow savers to provide funds to borrowers indirectly.

Functions of Commercial Banks

The functions of commercial banks can be classified into two types:

١. Primary functions

٢. Secondary functions

١. The Primary Functions:

This is the main function which is performed compulsorily by every bank or we can say that the organization which performs these functions is known as bank. The primary functions of commercial banks include: accepting deposits and granting loans and advances.

A. Accepting deposits:

The most important activity of a commercial bank is to mobilize deposits from the public. People who have surplus income and savings find it convenient to deposit the same with banks. Depending upon the nature of deposits, funds deposited with bank also earn interest. Thus, deposits with the bank grow along with the interest earned.

- **Demand deposit:** if a depositor deposits money in the bank in current account he can withdraw it in part or in full at any time he likes without notice. These accounts are generally kept by businessmen whose requirements of making business payments are quite uncertain. Usually no interest is paid on this account because bank cannot utilize these short-term deposits for lending purposes and must keep almost cent per cent reserve against them.
- **Fixed deposit or Time deposit:** these deposits are made for a fixed period of time, which is various from fifteen days to a few years. These deposits cannot, therefore, be withdrawn before the expiry of that period. However, a loan can be taken from the bank against the security of these deposits within that period.
- **Saving bank deposits:** in this case the depositor can generally withdraw money usually once a week. Sometimes there are also restrictions as to the total amount that can be withdrawn at one time and the total amount that can be placed in one deposit. These deposits are generally made by people with fixed salaries for holding their short-term savings.

B. Grant of loans and advances:

The second important function of a commercial bank is to grant loans and advances. Such loans and advances are given to members of the public and to the business community at a higher rate of interest than allowed by banks on various deposit accounts. The rate of interest charged on loans and advances varies according to the purpose and period of loan and also the mode of repayment. The bank makes profit by advancing loans. The commercial banks grant funds to the firms, businessmen, individuals, in different forms.

٢- The Secondary Functions:

In addition to the primary functions of accepting deposit and lending money, commercial banks had performed a number of other functions, which are called secondary functions. They are as follows:

A. Providing letters of credit, travelers, checks, etc.
B. Providing safe custody of valuables, important document and securities by performing safe deposit vaults or lockers.
C. Providing customers with facilities of foreign exchange dealings.
D. Transferring money from one account to another and from one branch to another branch of the bank through checks, pay order, etc.
E. Sending guarantee on behalf of its customers, for making payment for purchase of goods, machinery, vehicles, etc.

Chapter ٣: The Bank Management

The Bank Balance Sheet (Assets and Liabilities)

Now that you have some idea of how a bank operates, let's look at how a bank manages its assets and liabilities in order to earn the highest possible profit. The bank manager has four primary concerns. **The first** is to make sure that the bank has enough ready cash to pay its depositors when there are deposit outflows, that is, when deposits are lost because depositors make withdrawals and demand payment. To keep enough cash on hand, the bank must engage in liquidity management, the acquisition of sufficiently liquid assets to meet the bank's obligations to depositors.

Second, the bank manager must pursue an acceptably low level of risk by acquiring assets that have a low rate of default and by diversifying asset holdings (asset management). **The third** concern is to acquire funds at low cost (liability management). Finally, the manager must decide the amount of capital the bank should maintain and then acquire the needed capital.

The Bank Balance Sheet

Basically, balance sheet is a list of bank's assets and liabilities. As the name implies, this list balances and it has the characteristic that

Total assets = total liabilities + capital

The balance sheet, sometimes referred to as the statement of financial position, reports assets, liabilities, and stockholders' equity of a business enterprise at specific date. Table (١) below presents a basic element a bank balance sheet.

Table (١) Basic Elements of Bank Balance Sheet	
Assets	Liabilities
Cash $٣٠٠٠,٠٠٠	Fixed-term deposits $٩٠٠٠,٠٠٠
Reserves $٥٠٠,٠٠٠	Borrowings $٥٠٠٠,٠٠٠
Loans	Bank capital $٦٠٠٠,٠٠٠
Non-mortgages loans $١٠,٠٠٠,٠٠٠	Equity $١٠٠٠,٠٠٠
Mortgages $٥٠٠٠,٠٠٠	
Other assets $٢,٥٠٠,٠٠٠	
Total $٢١,٠٠٠,٠٠٠	Total $٢١٠٠٠,٠٠٠

Assets Management

We can examine the basic strategy a bank pursues in managing its assets. To maximize its profits, a bank must simultaneously seek the highest returns possible on loans and securities, reduce risk, and make adequate provisions for liquidity by holding liquid assets. Banks try to accomplish these three goals in four basic ways.

First, banks try to find borrowers who will pay high interest rates and are unlikely to default on their loans. They seek out loan business by advertising their borrowing rates and by approaching corporations directly to solicit loans. It is up to the bank's loan officer to decide if potential borrowers are good credit risks who will make interest and principal payments on time (i.e., engage in screening to reduce the adverse selection problem). Typically, banks are conservative in their loan policies; the default rate is usually less than ١٪. It is important, however, that banks not be so conservative that they miss out on attractive lending opportunities that earn high interest rates.

Second, banks try to purchase securities with high returns and low risk. Third, in managing their assets, banks must attempt to lower risk by diversifying. They accomplish this by purchasing many different types of assets (short- and long-term, U.S. Treasury, and municipal bonds) and approving many types of loans to a number of customers. Banks that have not sufficiently sought the benefits of diversification often come to regret it later. For example, banks that had overspecialized in making loans to energy companies, real estate developers, or farmers suffered huge losses in the ١٩٨٠s with the slump in energy, property, and farm prices. Indeed, many of these banks went broke because they had "put too many eggs in one basket."

Finally, the bank must manage the liquidity of its assets so that it can satisfy its reserve requirements without bearing huge costs. This means that it will hold liquid securities even if they earn a somewhat lower return than other assets. The bank must decide, for example, how much in excess reserves must be held to avoid costs from a deposit outflow. In addition, it will want to hold U.S. government securities as secondary reserves so that even if a deposit outflow forces some costs on the bank, these will not be terribly high. Again, it is not wise for a bank to be too conservative. If it avoids all costs associated with deposit outflows by holding only excess reserves, losses are suffered because reserves earn no interest, while the bank's liabilities are costly to maintain. The bank must balance its desire for liquidity against the increased earnings that can be obtained from less liquid assets such as loans.

Liquidity Management

Liquidity describes "the amount of time that is expected to elapse until an asset is realized or otherwise converted into cash or until liability has to be paid". Liquidity is very important issue for banks because most of their loanable funds are short-term checkable accounts. Therefore, all banks must keep sufficient liquidity in order to meet the daily withdrawals by depositors. Banks may face problems due to the shortage in liquidity.

Banks therefore, always maintain sufficient liquidity to meet the daily demands on the deposits. In case of over demand on deposits excess the cash in hand and the excess reserves, banks mainly have four channels to get extra funds which are, **borrowing from other banks, selling securities, borrowing from the central bank, and selling off loans.**

Capital Adequacy Management

Banks have to make decisions about the amount of capital they need to hold for three reasons. First, bank capital helps **prevents bank failure,** a situation in which the bank cannot satisfy its obligations to pay its depositors and other creditors and so goes out of business. Second, the amount of capital **affects returns for the owners** (equity holders) of the bank. And third, a minimum amount of bank capital (bank capital requirements) is **required by regulatory** authorities.

Risk Management in Banks

Since the risks that a bank has to manage are diverse, several classifications have been proposed, some of which are standard. The classification that use stems from the classification of banking activities as the following:

A. Credit risk

Credit risk is the risk that the promised cash flows from loans and securities held by banks may not be paid in full. It is related to the risk of default of a specific borrower, or to the risk of delay in servicing the loan. In either case, the present value of the bank's assets declines and this undermines the solvency of the bank.

B. Interest rate risk

Interest rate risk is the risk incurred by a bank when the maturities of its assets and liabilities are mismatched and there are changes in market interest rates. This risk derives from a primary function of banks, known as maturity transformation which means the liabilities (deposits) of banks are on average of a much shorter maturity than their assets (loans). The traditional role of banks is to make long-term loans and fund them by issuing short-term deposits.

C. Market risk

Market risk is the risk related to the uncertainty of a bank's earnings on its trading portfolio caused by changes in the market conditions, such as interest rates, equity return, exchange rates, market volatility, and market liquidity. Therefore, market risk is actually a collection of different risks including interest rate risk, equity price risk, commodity price risk and foreign exchange risk. These risks are associated with active trading of assets and liabilities (and derivatives) rather than holding them over longer horizons.

D. liquidity risk

liquidity risk focuses on the risk of an unexpected large withdrawal of funds by retail depositors (and the consequent obligation for the bank to make payments) which may oblige the bank to liquidate assets in a very short period of time and at low prices.

E. Operational risk

Operational risk is ‘the risk of direct or indirect loss resulting from inadequate or failed internal processes, people, and systems or from external events.

Justifications of Bank Regulations

Several economic and non-economic reasons have been given to justify banking regulations.

A. To protect depositors, the protection of the public (especially depositors) represent good justifications for regulations of banks.
B. To assure the safety of banks.
C. To avoid (or to limit) the effects of bank failures.
D. To maintain monetary stability.
E. To protect the payment system.
F. To encourage efficiency and competition in the financial system and in the economy.

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