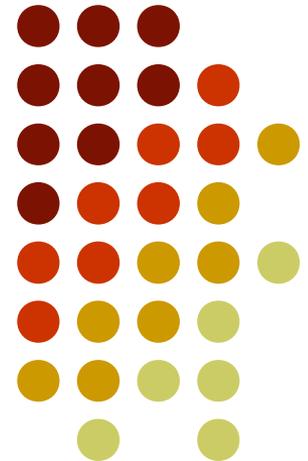
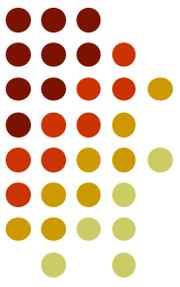


# Banks

## Chapter 2

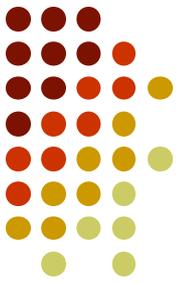




# Nature of Banking

- Commercial banking
  - Taking deposits, making loans (wholesale or retail)
  - Money center banks operate in the wholesale market and often fund themselves by borrowing
- Investment banking
  - Raising debt and equity for companies; advice on mergers and acquisitions, restructurings, trading, etc

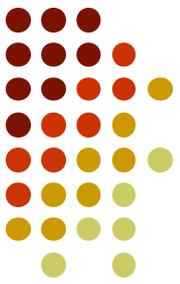
# Structure of Banking in the US



- Large international banks (small number)
- Regional banks (several hundred)
- Small community banks (several thousand)

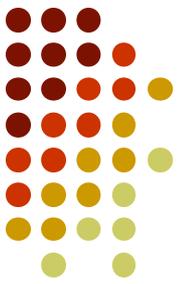
# History of Bank Regulation in US

(page 27)



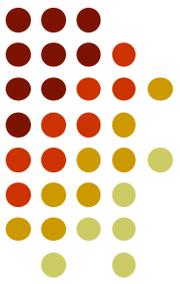
- McFadden Act (1927, 1933)
- Douglas Amendment (1956)
- Bank Holding Companies Act (1970)
- Riegel-Neal Interstate Banking and Branching Efficiency Act (1994)

# Example of Simple Bank Balance Sheet: End 2015 (Table 2.2, page 28)

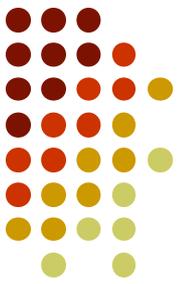


<b>Assets</b>		<b>Liabilities</b>	
Cash	5	Deposits	90
Marketable Securities	10	Subord L.T. Debt	5
Loans	80	Equity Capital	5
Fixed Assets	5	Total	100
Total	100		

# Income Statement: 2015 (Table 2.3, page 29)



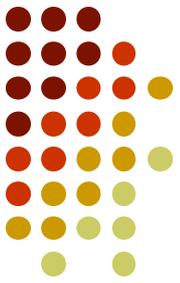
Net Interest Income	3.00
Provision for Loan Losses	(0.80)
Non-Interest Income	0.90
Non-Interest Expense	(2.50)
Pre-Tax Operating Income	0.60



## Year 2016

- What happens in year 2016 if it is the same as year 2015 except that provision for loan losses is 4.0 instead of 0.8?

# What if Balance Sheet Had Been More Aggressive?

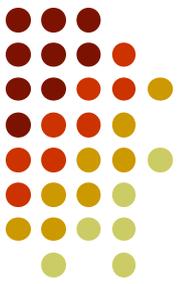


## Assets

Cash	5
Marketable Securities	10
Loans	80
Fixed Assets	5
Total	100

## Liabilities

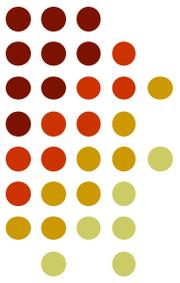
Deposits	94
Subord L.T. Debt	5
Equity Capital	1
Total	100



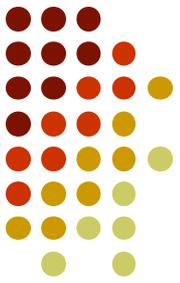
# Regulation

- Regulators set minimum levels for the capital a bank is required to keep
- Equity is an example of Tier 1 capital
- Subordinated long term debt is an example of Tier 2 capital

# Deposit Insurance (pages 30-31)



- Most countries have deposit insurance programs that insure depositors against losses up to a certain level
- In the US the FDIC has provided protection for depositors since 1933
- The amount insured was \$2,500 in 1933
- It has been increased several times
- Following the credit crisis it was increased from \$100,000 to \$250,000 in October 2008.
- Why might deposit insurance encourage a bank to take risks?

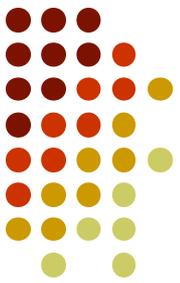


# Investment Banking

- Methods of raising debt or equity
  - Public offering
  - Private placement
  - Best efforts
  - Firm commitment

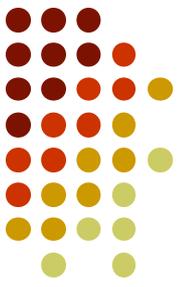
# Best Efforts vs Firm Commitment

(page 32)



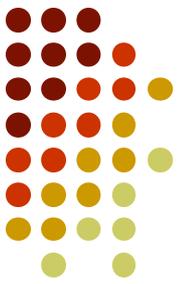
- 50 million shares are to be issued and target price is \$30 per share
- Best efforts would lead to a fee of 30 cents per share; firm commitment leads to bank buying the shares at \$30 per share

	Best efforts	Firm Commitment
Can sell at \$29	+\$15 million	-\$50 million
Can sell at \$32	+\$15 million	+\$100 million



# Initial Public Offering (IPO)

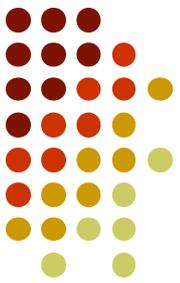
- Usually on a best efforts basis
- Bank will set offering price sufficiently low that shares are almost certain to be sold
- Often price rises immediately after IPO
- Banks often offer shares only to fund managers and their best customers



# Dutch Auction IPO

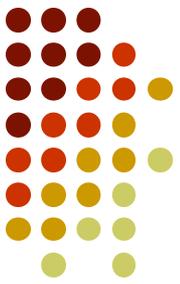
- Individuals and companies bid by indicating the number of shares they want and the price they are prepared to pay
- The price paid is the lowest bid that leads to all the shares being sold

# Example: How are 1 million shares allocated in this situation?

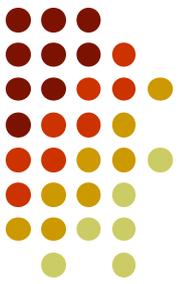


Bidder	Number of Shares	Price
A	100,000	\$30.00
B	200,000	\$28.00
C	50,000	\$33.00
D	300,000	\$29.00
E	150,000	\$30.50
F	300,000	\$31.50
G	400,000	\$25.00
H	200,000	\$30.25

# Google's IPO in 2004 (Business Snapshot 2.1, page 35)



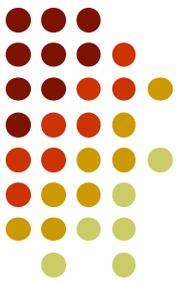
- A Dutch Auction where Google retained the right to change the number of shares that would be issued and the percentage allocated to each bidder
- Investors who bid \$85 or more obtained 74.2% of the shares they had bid for



# Securities Trading

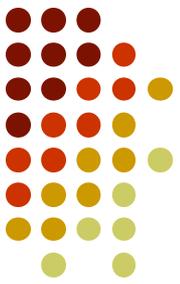
- Exchange-traded vs OTC
- Why do banks trade?
- Brokerage services
  - Full service
  - Discount
  - On line

# Potential Conflicts of Interest



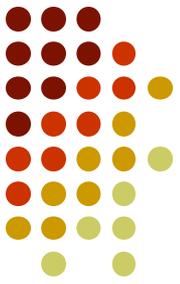
- Bank recommends securities investment bank is trying to sell
- Commercial bank passes confidential information on a client to investment bank
- Stock recommended as a “buy” to please company’s management in order to get investment banking business
- Investment bank sell securities for a company so that commercial bank can get rid of a loan

# Accounting (page 39)



- Banking book vs trading book
- Nonperforming loans are loans where interest is not accrued. Typically, payments from the borrower are more than 90 days overdue.
- When it becomes clear that payments will not be made, there is a loan loss
- A bank creates a reserve for loan losses

# The Originate-to-Distribute Model



- Very popular way of handling mortgages during the 2000 to 2007 period
- Banks originated loans and then packaged them into products that were sold to investors
- This frees up funds to make more loans