The Commercial Banking Industry

I. Introduction to Commercial Banking

We have been discussing banking already this semester, but now we want to look more closely at the products and services that commercial banks offer their customers (there are also investment banks or merchant banks, but we will discuss them next week). Banking activity can be divided into retail banks and wholesale banks. Retail banks are aimed at households and individuals, while wholesale banking is aimed at firms, government, merchant banks, financial institutions, and interbank operations (like money market and foreign exchange operations). Retail banks take deposits from households and firms and make loans to households and individuals. Wholesale banking involves such things as transactions between banks, such as very short term borrowing from /lending to other banks, as well as loaning to firms, government, institutions, and the buying, selling, and managing of foreign exchange (i.e. foreign money and assets held in overseas accounts).

Modern banking is often thought of as governed by the same economic logic as any other industry. In this case, banks are just firms taking raw materials (low cost funds) and turning them into an output (high valued funds). In doing this production of output, the bank will make use of labor and capital, just as any business would. It will also be worried about scale and the optimal size of the bank. It will engage in advertising and will be regulated, just as other types of firms are regulated. It will face foreign competition, just as other firms (say automobile firms) face stiff overseas competition. Bank must engage in constant innovation in order to survive - something that other types of firms also face. The principal difference between banks and other firms is that banks are absolutely central to the functioning of the economy. Every other industry uses banks on a daily basis, unlike common types of industries.

Banks use their funds (deposits, borrowings, and equity) to buy financial assets (not real productive assets). We saw this earlier when we found that banks have liabilities (deposits, borrowings, and equity) and they buy financial assets (reserves, securities, and loans). Banks are merely intermediaries taking funds from one group and providing these funds to other groups. In a world of perfect information and no spatial costs, such intermediation would not be
necessary. However, middlemen are extremely useful, as can be seen from the following diagram. I will discuss the idea behind this deceptively simple graph in class.

In effect, the graph is telling us that banks, by acting as middlemen, reduce search costs between lenders and borrowers. The banks get paid for this service, and as a result more funds are transacted in the market, borrowers will pay lower interest rates and lenders will get higher interest rates than they would have in the absence of banks. In addition, welfare (or profits and utility) in the system will also increase. Such a wonderful outcome helps explain why banks appeared in laissez-faire economies long before any help from the government.

It should be clear that banks (indeed all types of middlemen) perform a valuable service in the economy. The value of this banking service depends upon the difficulty in organizing (in the absence of banks) the process of lending and borrowing. For a small village in the past, this service was probably not very valuable, but in modern societies, with millions of lenders and borrowers, such organization is very valuable indeed. Of course, the element of trust is involved in banking. Without trust in banks, lenders and borrowers would be very reluctant to transact through banks. This is why that when trust falls and uncertainty rises in the banking industry, the whole economy
suffers. Tremendous costs arise that make even the simplest types of transactions impossible. To battle against such loss of confidence, banks are usually housed in large buildings with marble columns and imposing edifices. These are given big and exaggerated names like Manufacturer's Hanover Trust (merged and no longer existing) and Bank of America (still around), just to name two out of a host of other such names.

According to the Federal Reserve, there are 5693 commercial banks in the US as of 2014. In 1984, that number stood at 14,383. That's a 60% reduction in the number of banks. Obviously, there has been some pretty impressive mergers and consolidation within the commercial banking industry in the US. Even so, most of these thousands of banks are small in scale. According to Fed statistics, 63% of all deposits of commercial banks in the US are under the control of the largest or top 25 banks.

For Canadian banks, the banking industry includes 29 domestic banks, 24 foreign bank subsidiaries, 27 full-service foreign bank branches and three foreign bank lending branches operating in Canada. (Source: Office of the Superintendent of Financial Institutions as of May 2014). Japan has more banks than Canada. But, although there are over 190 banks in Japan, most banking is handled through four big sized banks - Mizuho Bank, Mitsui Sumitomo Bank, Tokyo Mitsubishi UFJ Bank, and Resona Bank.

II. Commercial Banking Products and Services

Commercial banks have a variety of products and services that they offer to their clients. However, we can broadly group these under borrowing and lending products. On the borrowing side, commercial banks offer accounts to customers to hold their money safely for them. Some of these require a fee and some pay interest.

Borrowings:

Transactions accounts, demand deposits, or current accounts involve the deposit of money by customers with the right to withdrawal at any time (on demand). These accounts are used to pay bills and transfer money. In the US, checking accounts can serve this function. Fees may be charged to cover the costs of clearing checks. Banks are allowed to pay interest on checking
accounts. And, there are also other types of accounts in US banks that are similar to these checking accounts.

Commercial banks also offer time deposits. These generally cannot be withdrawn on demand. You are required to notify the bank in advance that you intend to withdraw your money...otherwise there may be a substantial penalty. The notification period may be 7 days, one month, or even three months.

Banks may also borrow by issuing bank debentures. A bank debenture is a financial instrument issued by a bank to investors as a means of raising capital. The bank that issues a debenture agrees to make regular interest payments to the investor on what is essentially a loan from investor to the bank. At the conclusion of the term of the bank debenture, the bank returns the principal of the loan to the investor along with any remaining interest. Unlike a bond, a debenture is not secured by any specific collateral that the investor can claim upon default. The product the bank is offering in this case is a bond (debenture – non-collateralized).

Banks can also offer short term instruments like repo’s (repurchase agreements). Bank A can contract to sell a T-Bill today to Bank B with the stipulation that it will buy the T-Bill back the next day from Bank B at a slightly higher price. It will repurchase it. A reverse repo is where Bank A will offer to buy a T-Bill today from another Bank B with the stipulation that it will sell it back to Bank B at a slightly higher price.

Repo means --- sell, then buy back

Reverse repo means --- buy, then sell back

For the party selling the security (and agreeing to repurchase it in the future) it is a repo; for the party on the other end of the transaction, (buying the security and agreeing to sell in the future) it is a reverse repurchase agreement.

Lendings:

Commercial banks hold reserves, buy securities, and make loans. Loans may be for consumer loans, business loans, and mortgage loans. If it makes loans to businesses, government, or other
financial institutions, we say that it is doing wholesale banking activities. Consumer loans are retail banking activities and include such things as financing durable good payments like cars or washing machines. Credit cards are essentially short term consumer loans. Mortgage loans are bought by banks and typically involve the mechanism of self-liquidation. We will talk about self-liquidating loans more carefully in class. (See class notes)

Reserves may be thought of as lending money to the central bank. Of course, the central bank does not need money; it can simply print all the money it needs. So, most people think of a bank’s reserves as being placed at the central bank for safe keeping. A bank can call up these reserves if there is a sudden cash drain and they need liquidity. The Fed currently pays 0.25% on commercial bank reserves kept on deposit there.

Banks lend money to government as well. They do this by purchasing government securities. In the US this would include T-Bills, T-Notes, and T-Bonds. Banks also lend money to state and local governments, as well as government agencies (or government sponsored enterprises-GSEs).

**Delivery of Banking Services:**

There are essentially three ways of delivering banking services: branches, telephone, and internet. Branch banking is highly regulated since large banks could easily swamp smaller banks. This is particularly true in the US. Branch banking is increasing in emerging economies, while it is falling in most developed economies – excluding the US, where it has remained the same. Nearly all banks are moving towards 24 hour Internet service. The major difficulty here is the obvious problem of security.

In addition to retail commercial banking there is wholesale commercial banking. This is what we will discuss next week.