Bank Management

PROGAM: BACHELOR OF COMMERCE
COURSE UNIT: BANK MANAGEMENT
YEAR OF STUDY: III
SEMESTER: I

Learning objectives

- On completion of this chapter, you should be able to:
- To understand the role of financial intermediaries in the economy
- To understand lenders' and borrowers' different requirements and how banks can help to bridge such differences
- To understand how financial intermediaries reduce transaction, information and search costs
- To analyze the theories of financial intermediation
- Describe types of banking activity

Introduction

- What is a bank?
- The word ‘bank’ comes from the Italian word ***banco*** meaning a bench or a table at which Italian money lenders used to conduct business in the Middle Ages (approximately 1200-1500 AD).
- This Italian connection continues, as the oldest bank still in business today is Monte dei Paschi di Siena, founded in 1472.

Introduction

- The definition provided by the British Bankers' Association is as follows:
- 'A bank is an organization (financial intermediary) which accepts deposits, makes loans, pays cheques, and performs related services.'
- Nowadays banks also offer a wide range of additional services, but it is these functions that constitute banks' distinguishing features

Introduction

- Banks play a significant role in the financial system and the real economy.
- They intermediate between all sectors of the economy and other financial intermediaries and institutions.
- To understand how banks work, it is necessary to understand the role of financial intermediaries in an economy. This will help us to answer the question about why we need banks.

Understanding Financial intermediation

- The standard problem of external financing is the matching of agents in possession of funds with those in need of funds.
- This can be resolved in one of two ways:
- 1) with direct finance, where fund suppliers support demand through ownership participation (acquisition of equity positions) and/or the acquisition of debt instruments (for example, bonds) directly issued by the agents demanding the funds in financial markets; or
- 2) with indirect finance, where fund supply is funneled to “in-between” agents, the financial intermediaries, which are then responsible for the allocation to demand.
- Therefore, Financial intermediaries’ and financial markets’ main role is to provide a mechanism by which funds are transferred and allocated to their most productive opportunities.

Understanding Financial intermediation

- A bank is a financial intermediary whose core activity is to provide loans to borrowers and to collect deposits from savers. In other words they act as intermediaries between borrowers and savers, as illustrated in Figure 1.1. By carrying out the intermediation function, banks collect surplus funds from savers and allocate them to those (both people and companies) with a deficit of funds (borrowers). In doing so, they channel funds from savers to borrowers thereby increasing economic efficiency by promoting a better allocation of resources. This is referred to as Indirect Finance.

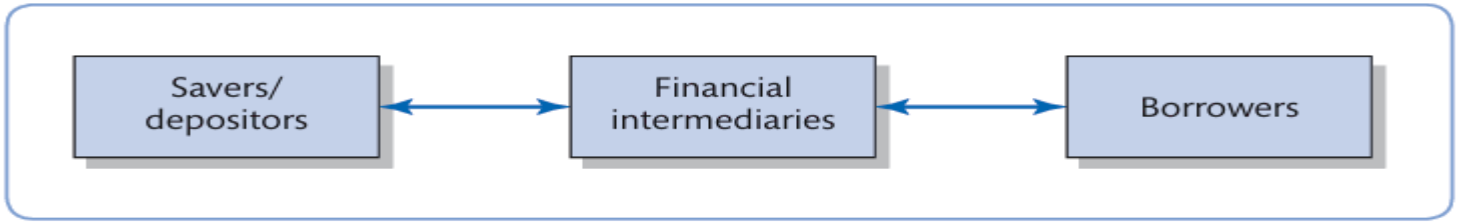

Figure 1.1 The intermediation function

Understanding Financial intermediation

- Direct finance, as shown in Figure 1.2, is where borrowers obtain funds directly from lenders in financial markets.

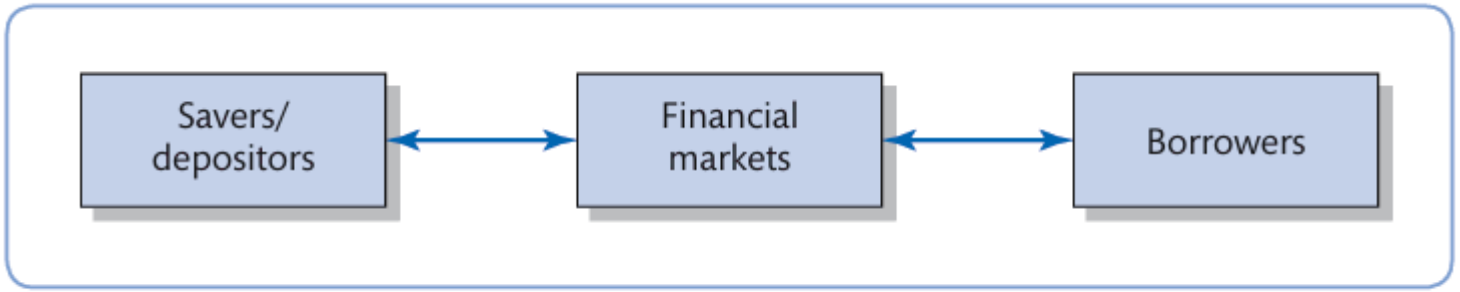

Figure 1.2 Direct finance

Understanding Financial intermediation

- Financial claims are generated whenever an act of borrowing takes place.
- A financial claim carries an obligation on the issuer to pay interest periodically and to redeem the claim at a stated value in one of three ways:
- 1 on demand;
- 2 after giving a stated period of notice;
- 3 on a definite date or within a range of dates
- 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**.
- Financial claims can take the form of any financial asset, such as money, bank deposit accounts, bonds, shares, loans, life insurance policies, etc.
- 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.

Understanding Financial intermediation

- The borrowing–lending process illustrated in Figure 1.2 does not require the existence of financial intermediaries. However, two types of barriers can be identified to the direct financing process:
- 1 The difficulty and expense of matching the complex needs of individual borrowers and lenders. 2 The incompatibility of the financial needs of borrowers and lenders. Lenders are looking for safety/ minimization of risk and liquidity. Borrowers may find it difficult to promise either.
- Lenders' requirements:

● The minimization of risk. This includes the minimization of the risk of default (the borrower not meeting repayment obligations) and the risk of assets dropping in value.

● The minimization of cost. Lenders aim to minimize their costs.

● Liquidity. Lenders value the ease of converting a financial claim into cash without loss of capital value; therefore they prefer holding assets that are more easily converted into cash. One reason for this is the lack of knowledge of future events, which results in lenders preferring short-term to long-term lending.

Understanding Financial intermediation

- Borrowers' requirements:
- Funds at a particular specified date.
- Funds for a specific period of time; preferably long-term (think of the case of a company borrowing to purchase capital equipment which will only achieve positive returns in the longer term or of an individual borrowing to purchase a house).
- Funds at the lowest possible cost.
- In summary, the majority of lenders want to lend their assets for short periods of time and for the highest possible return. In contrast the majority of borrowers demand liabilities that are cheap and for long periods.

Understanding Financial intermediation

- Financial intermediaries can bridge the gap between borrowers and lenders and reconcile their often-incompatible needs and objectives. They do so by offering suppliers of funds safety and liquidity by using funds deposited for loans and investments.
- Financial intermediaries help minimise the costs associated with direct lending – particularly **transaction costs** and those derived from **information asymmetries.**
- Transaction costs relate to the costs of searching for a counterparty to a financial transaction;1 the costs of obtaining information about them; the costs of negotiating the contract; the costs of monitoring the borrowers; and the eventual enforcements costs should the borrower not fulfil its commitments.
- In addition to transaction costs, lenders are also 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. Information asymmetries create problems in all stages of the lending process.

Understanding Financial intermediation

- Transaction costs and information asymmetries are examples of market failures; that is, they act as obstacles to the efficient functioning of financial markets.
- One solution is the creation of organized financial markets. However, transaction costs and information asymmetries, though reduced, still remain.
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- Another solution is the emergence of financial intermediaries. Organized financial markets and financial intermediaries co-exist in most economies; the flow of funds from units in surplus to units in deficit, in the context of direct and indirect finance, is illustrated in Figure 1.3.

Direct and indirect finance

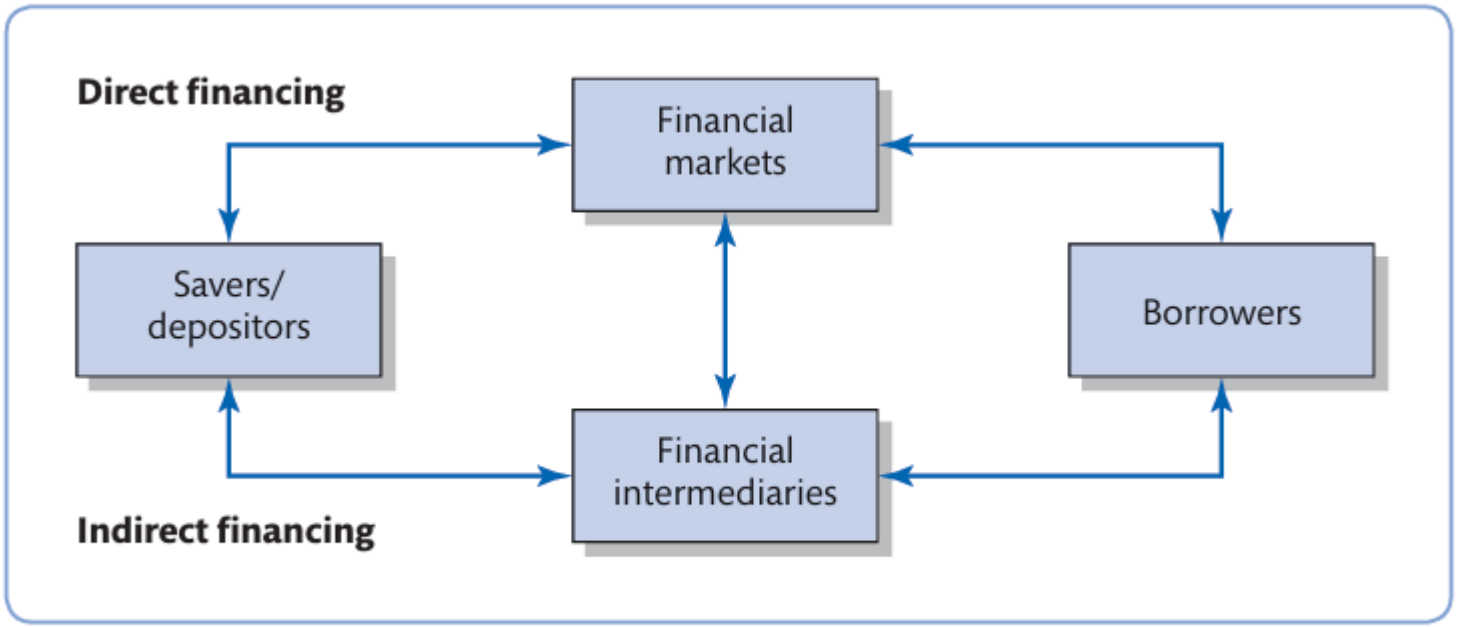

Figure 1.3 Direct and indirect finance

The role of banks

To understand fully the advantages of the intermediation process, it is necessary to analyze what banks do and how they do it.

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

Banks bridge the gap between the needs of lenders and borrowers by performing a transformation function

The role of banks

- **size transformation;**
- Generally, savers/depositors are willing to lend smaller amounts of money than the amounts required by borrowers. For example, think about the difference between your savings account and the money you would need to buy a house!
- Banks collect funds from savers in the form of small-size deposits and repackage them into larger size loans. Banks perform this size transformation function exploiting economies of scale associated with the lending/borrowing function, because they have access to a larger number of depositors than any individual borrower

The role of banks

- **maturity transformation;**
- Banks transform funds lent for a short period of time into medium- and long-term loans. For example, they convert demand deposits (i.e. funds deposited that can be withdrawn on demand) into 25-year residential mortgages. Banks' liabilities (i.e. the funds collected from savers) are mainly repayable on demand or at relatively short notice.
- Meanwhile, banks' assets (funds lent to borrowers) are normally repayable in the medium to long term. Banks are said to be 'borrowing short and lending long' and in this process they are said to 'mis match' their assets and liabilities.
- This mismatch can create problems in terms of liquidity risk, which is the risk of not having enough liquid funds to meet one's liabilities.

The role of banks

Risk transformation.

- Individual borrowers carry a risk of default (known as credit risk), which is the risk that they might not be able to repay the amount of money they borrowed. Savers, meanwhile, wish to minimize risk and prefer their money to be safe.
- Banks are able to minimize the risk of individual loans by diversifying their investments, pooling risks, screening and monitoring borrowers and holding capital and reserves as a buffer for unexpected losses.

Why do banks exist? Theories of financial intermediation

- There are five theories that explain why financial intermediation (banking) exists.
- These theories relate to:
- delegated monitoring;
- information production;
- liquidity transformation;
- consumption smoothing; and the role of banks as a commitment mechanism

Financial intermediation and delegated monitoring

- One of the main theories put forward as an explanation for the existence of banking relates to the role of banks as ‘monitors’ of borrowers.
- Since monitoring credit risk (likelihood that borrowers default) is costly, it is efficient for surplus units (depositors) to delegate the task of monitoring to specialized agents such as banks.
- 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

- If information about possible investment opportunities is not free, then economic agents may find it worthwhile to produce such information.
- For instance, surplus units could incur substantial search costs if they were to seek out borrowers directly. If there were no banks, then there would be duplication of information production costs as surplus units would individually incur considerable expense in seeking out the relevant information before they committed funds to a borrower.
- An alternative is to have a smaller number of specialist agents (banks) that choose to produce the same information.

Information production

- Banks have economies of scale and other expertise in processing information relating to deficit units – 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 (e.g. the knowledge of credit risk associated with different types of borrowers – ‘customer relationships’) they become experts in processing this information. As such they 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 former having to incur information costs.

Liquidity transformation

- Banks provide financial or secondary claims to surplus units (depositors) that often have superior liquidity features compared to direct claims (like equity or bonds). Banks' deposits can be viewed as contracts that offer high liquidity and low risk that are held on the liabilities side of a bank's balance sheets.
- These are financed by relatively illiquid and higher-risk assets (e.g. loans) on the assets side of the bank's balance sheet. It should be clear that banks can hold liabilities and assets of different liquidity features on both sides of their balance sheet through diversification of their portfolios.
- In contrast, surplus units (depositors) hold relatively undiversified portfolios (e.g. deposits typically have the same liquidity and risk features). The better banks are at diversifying their balance sheets, the less likely it is that they will default on meeting deposit obligations.

Consumption smoothing

- The three aforementioned theories are usually cited as the main reasons why financial intermediaries (typically banks) exist.
- However, studies have suggested that banks perform a major function as consumption smoothers. Namely, banks are institutions that enable economic agents to smooth consumption by offering insurance against shocks to a consumer’s consumption path.
- The argument goes that economic agents have uncertain preferences about their expenditure and this creates a demand for liquid assets. Financial intermediaries in general, and banks in particular, provide these assets via lending and this helps smooth consumption patterns for individuals.

. Structure of The Ugandan Financial Sector

- The Ugandan financial sector is constituted of: commercial banks, credit institutions, development banks, micro-finance institutions, insurance companies, pension funds, capital markets, money lenders, Savings and Credit Cooperatives (SACCOS) and village saving schemes.
- In addition, some telecommunication companies offer ‘deposit-like products’ which enable their subscribers to save and borrow small amounts of money on their mobile phones using virtual accounts.
- A number of the institutions within the financial sector are regulated by the Central Bank while others fall outside the mandate of the bank

Structure of The Ugandan Financial Sector

- The Ugandan financial sector is largely constituted of the following:
- 1) Deposit-taking financial institutions regulated by the Central Bank:
- a) Commercial banks - thirty three (33)
- b) Credit institutions - four (4)
- c) Microfinance deposit taking Institutions - four (4)

Structure of The Ugandan Financial Sector

2) Non-deposit taking institutions regulated by the Central Bank:

a) Forex bureaus and money remitters
b) b) Mobile money operators

Structure of The Ugandan Financial Sector

3) Financial institutions which are regulated by other organs of Government:

a) Insurance companies - regulated by the Insurance Regulatory Authority (IRA).
b) Pension Funds - regulated by Uganda Retirement Benefits Regulatory Authority (UBRA).
c) Capital markets - regulated by the Capital Markets Authority (CMA) includes; stock market (USE), Unit trusts, Private equity firms, REITs
d) Money lenders - Regulated by Uganda Microfinance Regulatory Authority (UMRA).
e) Non-deposit taking micro-finance institutions - regulated by UMRA f) Savings and Credit Cooperative (SACCOS) - regulated by UMRA.

Structure of The Ugandan Financial Sector

4) Others

a) Development banks such as the Uganda Development Bank and East African Development Bank
b) Village Savings and Loan Associations (VSLA)

Banking regulation and supervision