Handout 4: useful definitions and facts about banking

Related to Lecture 17:

The balance sheet of a bank: is a listing of its assets (what it owns), its liabilities (what it owes to others), and its bank capital (net worth) defined to be the difference between its assets and its liabilities.

Reserves: Vault cash (cash physically held by the bank) plus deposits held in an account at the Fed on which no interest is paid.

Required reserves: are held because, by law, the Fed requires that for every dollar of checkable deposits at a bank, a certain fraction (the required reserve ratio) must be kept as reserves. Required reserves can be calculated by multiply the amount of checkable deposits by the required reserve ratio.

Excess reserves: any additional reserves are referred to as excess reserves.

Secondary reserves: because of their liquidity, short-term U.S. government securities are sometimes called "secondary reserves."

The T-Account for a bank: is a simplified balance sheet that lists only the changes that occur in balance sheet items starting from some initial balance sheet position.

Related to Lecture 18:

credit risk: default risk that borrowers may fail to or unable to pay back principal and/or interest.

interest rate risk: arise because interest rates may vary unexpectedly, causing volatility in bank profits if the bank holds interest-sensitive assets (e.g., variable rate loans) and/or interest-sensitive liabilities (e.g., money market deposit accounts)

off-balance-sheet activities: are activities that affect bank profits but do not appear on bank balance sheets, and so are particularly hard for depositors and other outsiders to monitor.

Adverse selection between banks and borrowers: those with high credit risk (more likely to produce an adverse outcome) are the ones who usually line up for loans (mostly likely to be selected).
Moral hazard between banks and borrowers: borrowers (investors) have incentives to engage in activities that are undesirable in the bank’s view; in this case, the bank will be subjected to the hazard of default.

Loan commitment: is a bank’s commitment (for a specified future period of time) to provide a firm with loans up to a given amount at an interest rate that is tied to some market interest rate.

Credit rationing means banks refusing to make loans even though borrowers are willing to pay the stated interest rate or even a higher rate.

Restrictive covenants: provisions in loan contracts that prohibit borrowers from engaging in specified risky activities.

Loan sale (secondary loan participation): involves a contract that sells all or part of the cash stream from a specific loan and thereby removes the loan from the bank’s balance sheet.

Servicing mortgage-backed securities: collecting interest and principal payments and then paying them out.

Guarantees of debt: the bank promises to make interest and principal payments if the party issuing the security cannot. e.g. banker’s acceptances.

Related to Lecture 19:

Adjustable-rate mortgages: mortgage loans on which the interest rate changes when some specified market rate changes.

Bank credit and debit cards: Sears, Macy’s, JCPenny, Younkers ➔ lower costs (default cost, stolen cards, processing transactions) ➔ late 1960s 2 credit card programs: visa, master card. Debit card earn from fees paid by stores, depend more on low transaction costs; credit card earn from interest payments

Electronic banking:

Automated teller machines (ATMs) By not owning or renting an ATM, but instead letting it be owned by someone else and simply paying the owner a fee for each transaction, banks can effectively use ATMs as surrogate branches.
**Junk bonds** are corporate bonds that are rated below Baa (by Moody's rating system) or below BBB (by Standard & Poor's rating system).

**Commercial paper** is a *short-term* debt security issued by large banks and corporations.

**Securitization** is the process of transforming otherwise illiquid financial assets (e.g., residential mortgages, automobile loans, credit card receivables,...) into more marketable securities.

**Money market mutual funds** issue shares, redeemable at a fixed price (e.g., $1 per share), that effectively function as interest-earning checking accounts.

**Disintermediation**: people began to take their money out of banks and seek out higher-yielding investments.

**Related to Lecture 20:**

**Bank holding companies** are companies that own one or more banks. Bank holding companies can own a controlling interest in several banks even if branching is not permitted. Many states permit bank holding companies in other states to own controlling interests in banks in their state.

a wider scope of activities: provision of investment advice, data processing and transmission services, leasing, credit card services

**Bank consolidation**: banks merge to create larger entities or buy up other banks.

**1994 Riegle-Neal Interstate Banking and Branching Efficiency Act**: This act essentially recognized a movement underway by states since 1985 to get around branching restrictions by various means. It overturned the McFadden Act's prohibition of interstate banking and established the basis for a true nationwide banking system. In doing so, it increased substantially the benefits of bank consolidation for the banking industry.

**The Gramm-Leach-Bliley Act of 1999**: The principal focus of the Gramm-Leach-Bliley (GLB) Act of Fall 1999 is the relaxation of the provisions of the Glass-Steagall Act of 1933 requiring separation of commercial banking and securities activities. Specifically, the GLB Act eases the way for banks and nonbanking firms to consolidate in some fashion to take advantage of the synergies and cost advantages perceived in such combinations.