**Chapter 1**

**Banking and the Financial Services Industry**

Chapter Objectives

1. Describe the cause and consequences of the credit crisis of 2007 – 2009.
2. Describe the similarities and differences between a bank holding company and a financial holding company.
3. Describe various banking models.
4. Describe various channels for delivering banking services.

Key Concepts

1. “Sub-Prime” mortgages led to much of the credit crisis of 2007 – 2009. Many lenders made mortgages:
   1. to borrowers with insufficient income to make the monthly payments,
   2. with low teaser rates,
   3. low payments resulting in negative amortization.

As these mortgages defaulted, many mortgage companies saw their capital depleted. Declining real estate values had the largest impact in the areas that had the highest run-up in property values. Larger banks tended to experience large losses while many small banks did not.

1. After the failure of several large financial institutions, the government responded by:
   1. placing Fannie Mae and Freddie Mack into conservatorship,
   2. loaning AIG over $150 billion,
   3. temporarily increasing FDIC coverage to $250,000,
   4. insuring money market mutual funds.
   5. establishing the Troubled Asset Relief Program (TARP)
   6. establishing the Term Asset-Backed Securities Loan Facility (TALF)
   7. Investing $125 billion in several large U.S. banks,
   8. promoting mortgage loan modifications.
2. Banks differ in terms of their size and the scope of products they offer. Global banks offer a wide array of products and services globally. Super-Regional Banks are similar to global banks but smaller in size and market penetration, while Community Banks typically have a smaller trade area and total assets under $1 billion.
3. Banks are often part of a Bank Holding Company or a Financial Holding Company. The primary advantage to forming a Financial Holding Company is that the entity can engage in a wide range of financial activities not permitted in the bank or in a Bank Holding Company.

Financial Holding Companies are authorized to engage in:

* 1. underwriting and selling insurance and securities,
  2. commercial banking,
  3. merchant banking,
  4. insurance company portfolio investment activities.

1. The Federal Reserve may not permit forming a Financial Holding Company if any of its insured depository institution subsidiaries are:
   1. not well capitalized,
   2. not well managed,
   3. did not receive at least a “Satisfactory” rating in its most recent CRA exam.
2. The consolidated financial statements of a holding company and its subsidiaries reflect aggregate or consolidate performance. The parent typically pays very little in income tax because 80 percent of the dividends from subsidiaries is exempt. Taxable income from the remaining 20 percent and interest income is small relative to deductible expenses.
3. Large Banks are typically organized as C-Corporations, while smaller banks are organized as S-Corporations. S-Corporations receive favorable tax treatment because the firm does not pay corporate income tax. The firm allocates income to shareholders on a pro rata basis and each individual pays tax at personal tax rates on the income allocated to them. Given the ability to avoid the double taxation at the firm and individual level, many closely held banks have chose S-corporation status. The primary limitation to qualifying for S-corporation status is a requirement that the bank must have no more than 100 shareholders.
4. The principal advantage of being a depository institution is access to FDIC deposit insurance. The primary disadvantage of operating as a bank (or Bank Holding Company) is that the firm is subject to regulation as a bank.
5. There are major financial services business models: Transactions Banking and Relationship Banking. Transactions banking involves providing transactions services such as checking accounts, credit card loans, and mortgage loans that occur with high frequency and exhibit standardized features. Because the products are highly standardized, they require little human input to manage. Relationship banking emphasizes the total relationship between the banker and customer. Relationship banks will often aggressively market noncredit products and services to such customers in order to lock in the relationship.
6. Securitization is the process of converting assets into marketable securities. It enables banks to move assets off balance sheet and increase fee income. It increases competition for the types of standardized products, such as mortgages and other credit-scored loans, and eventually lowers the prices paid by consumers by increasing the supply and liquidity of these products. This Originate-to-Distribute (OTD) approach of separating loan origination from ownership contributed to the credit crisis of 2007 – 2009. Lenders who originated the loans knew they would not own the loans long term, therefore, they were less concerned about the quality of the assets originated. In order to grow their business and continue originating loans, they increasingly made loans to less qualified borrowers. When the underlying assets defaulted at higher-than-expected rates, investors in the securities did not receive the promised payments. The net result is that liquidity largely dried up for most securitizations.
7. Universal Banking refers to a structure for a financial services company in which the company offers a broad range of financial products and services. It combines traditional commercial banking that focused on loans and deposit gathering with investment banking. The presumed advantage of universal banking is the ability to cross-sell services among customers. U.S. firms that have tried to achieve this goal of a “one-stop financial supermarket” have not outperformed more traditional competitors.
8. Too Big to Fail: Regulators and government officials argue TBTF firms are too connected to other large firms, and a failure could lead to a collapse of the global financial system and ultimately to a severe global recession. Smaller organizations are presumably less important economically and thus do not receive the same assistance and may be allowed to fail. The Dodd-Frank Act attempts to address the TBTF issue.
9. There are several channels for delivering banking services including:
   1. Branch Banking
   2. Automated Teller Machines
   3. Internet Banking
   4. Call Centers
   5. Mobile Banking

Teaching Suggestions

This chapter represents an opportunity to link bank management topics to current events. As a semester project, students should be encouraged to keep a file or log of events from recent newspapers or magazines that demonstrate the existence and impact of deregulation/reregulation, financial innovation, securitization, globalization, and technological advances. Students could be asked to i) keep a list of bank failures, and ii) keep a record of bank mergers and acquisitions. Tracking mergers and acquisitions among financial companies stimulates considerable debate as to why firms are entering or exiting specific lines of business, the costs and benefits of size or scale, advantages and disadvantages of operations that cross country boundaries, etc. Regular reference to *The Wall Street Journal* contributes to student understanding and interest.

Sample Projects and Assignments

* Have students select a financial holding company and evaluate its organizational chart. Identify the number and range of bank and non-bank subsidiaries.
* Have students analyze the data in Exhibits 1.2 and 1.3 regarding the number of institutions by type and asset size since 1997. The students should discuss the key implications.
* Have students keep a list of recent changes in banking regulations. The students should discuss the key implications.

Answers to End-of-Chapter Questions

1. * Goldman Sachs – Converted to a bank holding company.
   * Bear Stearns – Acquired by J.P. Morgan Chase.
   * Morgan Stanley – Converted to a bank holding company.
   * Lehman Brothers – Allowed to fail.
   * Merrill Lynch – Acquired by Bank of America.
2. * Mortgages are loans that are secured by residential or commercial real estate. As real estate prices started to decline, many institutions involved in mortgage lending began to realize losses from mortgage defaults. This led to the failure of many financial institutions.
   * Subprime loans are loans made to borrowers with low credit scores and thus a higher-than-average risk of default. Various types of subprime mortgages were offered to make the monthly payments affordable. When housing prices fell dramatically, institutions were required to report writedowns.
   * Asset writedowns are when a financial institution formally recognizes that loans they hold on their balance sheets are worth much less than the amount of funds owed. The writedowns, in turn, depleted the lenders’ capital and forced them to either sell assets or obtain external capital. Many financial institutions reacted by restricting credit availability to businesses and individuals.
3. A bank holding company is essentially a shell organization that owns and manages subsidiary firms. Any organization that owns controlling interest in one or more commercial banks is a bank holding company (BHC). One-bank holding companies (OBHCs) control only one bank, while multibank holding companies (MBHCs) control at least two commercial banks. The motivation behind a BHC (one- or multi-) is the firm’s desire to combine the bank’s capabilities with the financial activities of their non-bank subsidiaries in order to better compete. Financial holding companies (FHCs) are distinct entities from bank holding companies. A company can form a BHC, an FHC, or both. The primary advantage to forming an FHC is that the entity can engage in a wide range of financial activities not permitted in the bank or in a BHC. Some of these activities include insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities.
4. S-corporations have favorable tax treatment because a qualifying firm does not pay corporate income tax. The firm allocates income to shareholders on a percentage of ownership basis and each individual pays tax at personal tax rates on the income allocated to them.
5. Transactions banking involves the provision of transactions services such as checking accounts, credit card loans, and mortgage loans that occur with high frequency and exhibit standardized features. Because the products are highly standardized, they can be evaluated mechanically and require little human input to manage. For example, the decision to make a credit card loan is typically based on an individual’s credit score. This score can be readily used to grade the riskiness of the borrower. Lenders that generate sufficient volumes of transactions for these standardized products can offer them globally with limited investment in human capital. Thus, the transactions model encourages the use of technology to offer standardized products at prices low enough to discourage small firms from offering the same products. Banks that emphasize transactions banking are generally large and compete across extensive geographic and product markets.  
     
   Relationship banking emphasizes the personal relationship between the banker and customer. For example, the key feature of a loan that is relationship driven and not transactions driven is that the lender adds real value to the borrower during the credit granting process. In addition to the provision of funds, the lender may provide expertise in accounting, business, and tax planning. Loans to smaller firms are more difficult to credit score because they are not standardized. With relationship loans, lending institutions generally charge higher rates and often hold the loans in portfolio. They also aggressively market noncredit products and services to such customers in order to lock in the relationship. The familiarity between borrower and lender and convenience of completing transactions without starting the information search over encourages both the bank and customer to maintain the relationship over time. Borrowers will pay for the assurance that funds will be advanced as they are needed with minimal repetitive negotiations.

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| **Bank of America (2013)** | **Revenue** | |
| **Line of Business Revenue** |  |  |
| United States | $76,612 | 86.1% |
| Europe | $6,353 | 7.1% |
| Asia | $4,442 | 5.0% |
| Latin America | $1,535 | 1.7% |
|  | $88,942 | 100.0% |
| **Line of Business Revenue** |  |  |
| Consumer & Business | $29,867 | 33.3% |
| Global Banking | $16,481 | 18.4% |
| Global Wealth & Investments | $17,790 | 19.8% |
| Global Markets | $16,058 | 17.9% |
| Consumer Real Estate | $7,716 | 8.6% |
| All Other | $1,889 | 2.1% |
|  | $89,801 | 48.1% |

The Consumer & Business line of business accounted for 33.3% of the bank’s revenue. The Global areas collectively generated 56.1% of the bank’s revenue. Consumer & Business are likely to be the most predictable and stable earnings, compared to the global and consumer real estate markets.

1. I) Additional regulation will encourage consolidation, which will sharply reduce the number of independent commercial banks. II) The TARP program continues to reduce the number of independent commercial banks as it encourages consolidation for the banks with TARP preferred stock outstanding. III) Independent banks have less flexibility compared to bank holding companies in terms of the number and breadth of activities they can engage in. This reduces the competitiveness of the independent bank.
2. * Branch Banking: The two most common types of branches are standalone brick-and-mortar buildings and in-store branches. Brick-and-mortar branches typically offer a complete set of banking services including loans, deposits, and money management/trust services. Often they have drive-up windows attached to help handle customer flow. In-store branches are typically located in retail outlets and offer a limited range of services. One popular type of in-store branch is located in supermarkets characterized by high-volume traffic. Older customers are more likely to use branch banking.
   * Automated Teller Machines: ATMs are computerized telecommunications systems that offer limited bank services without direct human involvement. Virtually all ATMs in the U.S. are connected to networks, which allow a user to conduct business with his or her bank regardless of where the user’s bank is located. Typically, the bank that owns or hosts the ATM will charge a fee to the user for the access. Younger customers and older customers that are comfortable with technology are the likely users of ATMs.
   * Internet (Online) Banking: Most banks allow customers to access their account information and conduct routine banking business via secured Web sites. Typical services include account review, bill payment, wire transfer of funds, and applications for loans and new accounts. The primary appeal of Internet banking is its convenience, because customers can conduct their banking business virtually at any time and in any place that has Web access. The primary disadvantage of Internet banking is that thieves have had success in stealing account information from individuals and quickly depleting account balances. Younger customers are likely users of online banking.
   * Call Centers: These are intended to benefit a bank’s retail customers. A center consists of a centralized location designed for a bank’s employees to receive and transmit calls. Banks use call centers primarily for handling customer inquiries and for telemarketing efforts and debt collection. Customers uncomfortable with computer technology will be likely users of call centers.
   * Mobile Banking: This allows customers to use of cell phones to conduct banking business. This speeds up transactions processing and increase customer convenience. Younger customers will likely prefer mobile banking.