FPT Fpt University
FPT SCHOOL OF BUSINESS (FSB)

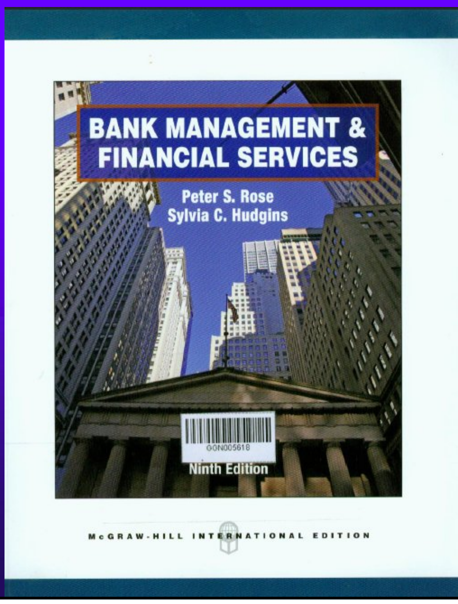
Introduction of course

Principles of Banking

Prepared by Dinh, T.N. Huy

Dec 2012

Learning materials



Learning materials

Chapter 3 (section 1)

THE ORGANIZATION AND STRUCTURE OF BANKING AND THE FINANCIAL-SERVICES INDUSTRY

Prepared by Dinh, T.N. Huy

June 2012

Agenda

1. Overview
2. Definition
3. Organization and Structure of CBs
4. Internal organization of banks
5. Types in the banking industry
6. Interstate banking
7. Riegle - Neal Interstate banking
8. Financial holding company
9. Financial firm goals
10. Summary

Overview

- In modern banking nowadays, small banks lose market share to larger banks

Small: USD 1 b assets; medium: 1-25 b; large: >25 b

Overview

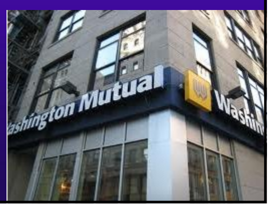
- Roles of banks/financial firms:

+ Providers of credit
+ Channels for making payment
+ Repositories of the public’s savings
+ Trustees of customer’s properties

Overview

- Roles of banks/financial firms: (cont.)

+ Managers of business and household cash balances
+ Providers of risk protection
+ Brokers charged with purchases /sales of securities
+ CBs are dominant supplier of credit and payment services



Basic Concepts

- Unit banks:

Unit banks offer their full menu of services from only one office, though they may operate any number of drive-in windows, automated teller machines that are linked to the bank’s computer system. These organizations are very common today.

Basic Concepts

- A branch banking organization:

A branch banking organization sells its full menu of services through several locations, including a head office and one or more full-service branch offices. Regardless of its number of offices it is one corporation with one board of directors.

Basic Concepts

- A bank holding company:

  A corporation that holds an ownership interest in at least one bank. It is also allowed to own nonbank businesses as long as they are related to banking.

Basic Concepts

- Agency theory:

  It analyzes the relationship between a firm’s owner (shareholder) and its managers. It explores whether there is a mechanism to compel managers to act in the best interest and maximize the welfare of the firm’s owners. Owners do not have access to all the information and cannot fully evaluate the performance of a manager.

Basic Concepts

- Corporate governance:

It describes the relationships that exist among managers, the board of directors, the stockholders, and other stakeholders of a corporation. Corporate governance can be improved through larger boards of directors and a high proportion of outside directors. This will expose managers to greater monitoring and discipline

Basic Concepts

- Expense-preference behavior:

Expense preference behavior describes an approach to management in which managers use the resources of the firm to provide them with personal benefits not needed to produce and sell the products. This behavior leads to increasing costs of production and declining returns to the firm’s owners.

Organization and structure of CBs

- Organizational forms follow functions
- It also follows regulations and laws
- And it follows roles and size

Organization and structure of CBs

- Structure of banks in the US:

+ In 2009, about 2500 US small CBs held assets of less than USD 100 m
+ During 2007-2009 crisis, over a hundred of these small organizations failed /overwhelmed by bad loans

Organization and structure of CBs

- Structure of banks in the US:
+ 100 largest US banks hold close to 90% of industry-wide assets (Citigroup, JP Morgan Chase, Bank of America,…)
+ see more in Exhibit 3.1

Internal Organization of banks

- Community banks and other community-oriented financial firms
- Larger banks-money centers, wholesale and retail
- Trends in organization

Community banks and other community-oriented financial firms

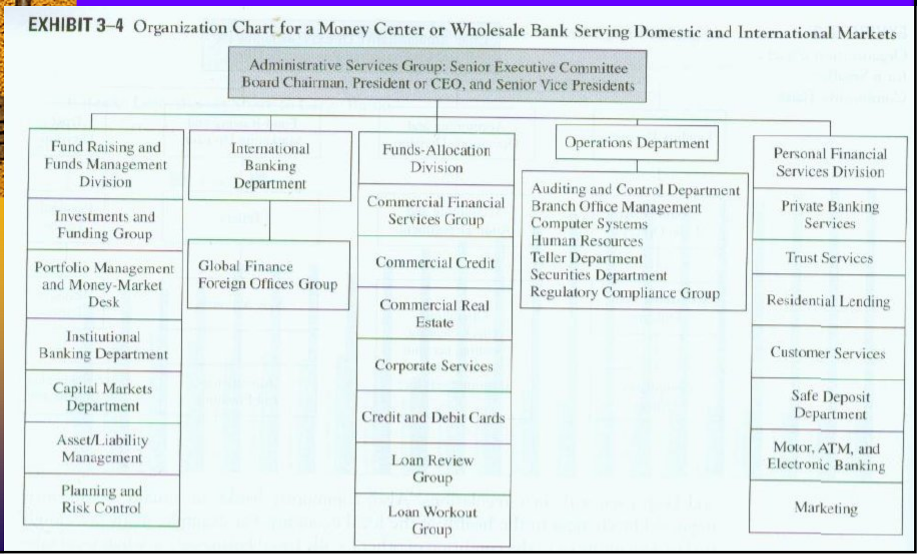
- Community banks serve smaller cities and towns and the market for smaller, locally based deposits and loans (also called retail bank)
- While wholesale banks such as Citibank of NY makes large corporate loans

Community banks and other community-oriented financial firms

- Reporting in a community bank:

+Cashier and auditor (accounting depart.)
+VP (loans, marketing, fund raising)
-> Senior executives, includes
+ Board chairman
+ President
+ Senior VP (long-term planning)
-> Board of directors (policy and monitor performance)

Larger banks-money centers, wholesale and retail



Larger banks-money centers, wholesale and retail

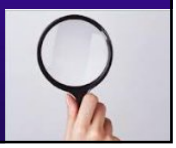
- Examples: Citigroup, Deutsche bank, JP Morgan Chase receive half or more of earnings from outside
- Serve many different markets with different services
- Can raise huge amount of capital at low costs

Trends in organization

- When a financial firm grows, it adds more services and facilities and becomes a complex organization with internet and computer-based systems
- More financial firms are *market driven* and *sales oriented* and have more people with computer skills/electronic equipments

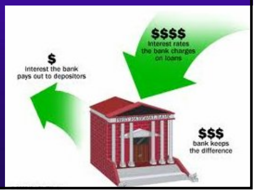
The Array of Organizational Structures and Types in the Banking Industry

- Unit Banking Organizations
- Branching Organizations
- Electronic Branching-Web Sites and Electronic Networks
- Holding Company Organizations



Unit Banking Organizations

- Offer all of their services from *one office* (taking deposits, cashing checks, paying bills)
- Some services offered through limited-service facilities (drive-up windows and ATMs)



Unit Banking Organizations

- In 2009, about one-quarter or just 1600 US CBs with no full-service branches while about 5200 US CBs had full-service branches
- In the age of electronic banking and megamergers, many new banks formed as unit firms due to limited capital and staff

Branching Organizations

- Offer full range of services from several locations (a H.O and one or more full-service branch offices)
- Can offer limited services through drive-up windows, ATMs, point-of-sale terminals in stores and shopping centers, internet

Branching Organizations

- Senior management sits at the home office
- Management at full-service branch has Limited authority to make decisions on customer loan applications
- Some services/functions are highly centralized while others are decentralized

Branching Organizations

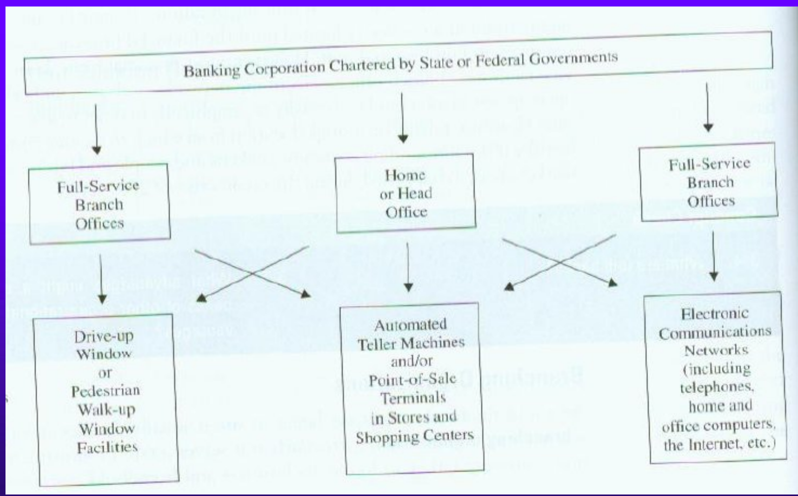


EXHIBIT 3–6
The Branch Banking Organization

Branching Organizations

TABLE 3–2
Growth of Commercial Bank Branch Offices in the United States

Source: Federal Deposit Insurance Corporation.

Year	Number of Bank Home (Main) Offices	Number of Branch Offices	Total of All U.S. Bank Offices	Average Number of Branches per U.S. Bank
1934	14,146	2,985	17,131	0.21
1940	13,442	3,489	16,931	0.26
1952	13,439	5,486	18,925	0.41
1964	13,493	14,703	28,196	1.09
1970	13,511	21,810	35,321	1.61
1982*	14,451	39,784	54,235	1.75
1988	13,137	46,619	59,756	2.55
1993	10,960	52,868	63,828	3.82
1999	8,551	63,684	72,265	6.45
2001	8,096	64,938	73,034	7.02
2002	7,887	66,185	74,072	7.39
2003	7,769	67,390	75,159	8.67
2004	7,630	69,975	77,605	9.17
2005	7,527	72,775	79,802	9.67
2006	7,368	75,883	83,251	10.30
2007	7,241	78,873	86,114	10.89
2008	7,049	79,397	86,446	11.26
2009	6,808	81,276	88,174	11.78
2010	6,503	81,184	87,687	12.48

Electronic Branching-Web Sites and Electronic Networks: An Alternative or Supplement to Traditional Bank Branch offices?

- These include:

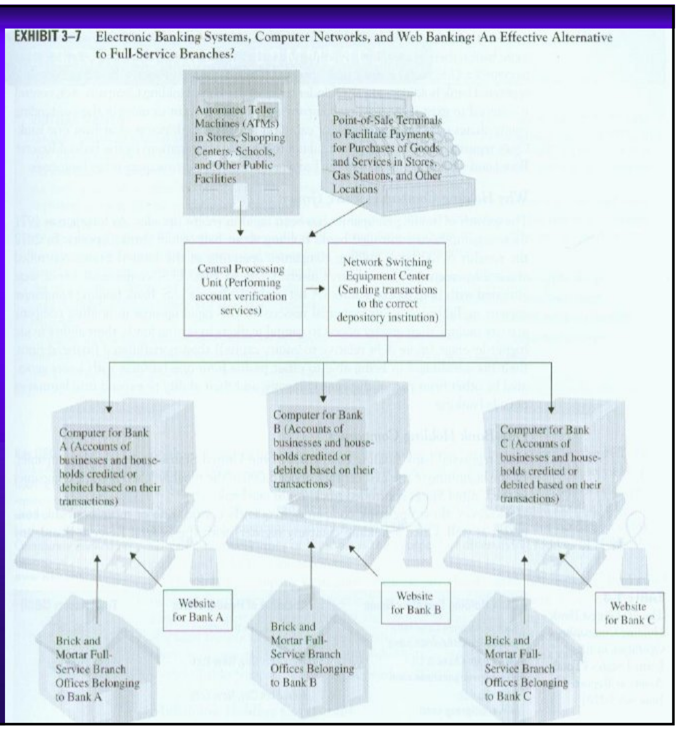
+ Website offering internet banking services
+ ATM network dispensing cash and accepting deposits
+ POS terminals in stores to pay for goods
+ Personal computers, call-center systems

Electronic Branching-Web Sites and Electronic Networks: An Alternative or Supplement to Traditional Bank Branch offices?

- Customers can:

+ Check account balances
+ Set up new accounts
+ Pay bills, request loans
+ Move funds b.t accounts

Electronic Branching-Web Sites and Electronic Networks: An Alternative or Supplement to Traditional Bank Branch offices?



Chapter 3 (section 2)

THE ORGANIZATION AND STRUCTURE OF BANKING AND THE FINANCIAL-SERVICES INDUSTRY

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June 2012

Basic Concepts

- Consolidation:

In business, it refers to the merger or acquisition of many smaller companies into the much larger firms.

Basic Concepts

- Economies of scale:

The company can reduce average cost per unit when output products increase because of fixed cost

Basic Concepts

- Economies of scope:

  One firm can produce 2 products and lower costs. It is said to be better than 2 firms produce 2 same products.

Holding Company Organizations

- A bank holding company: A corporation chartered for the purpose of holding the stock of at least one bank, along with other businesses
- In the US, if a firm wants to control a bank, it needs 25% or more of the stock and approval from Federal Reserve

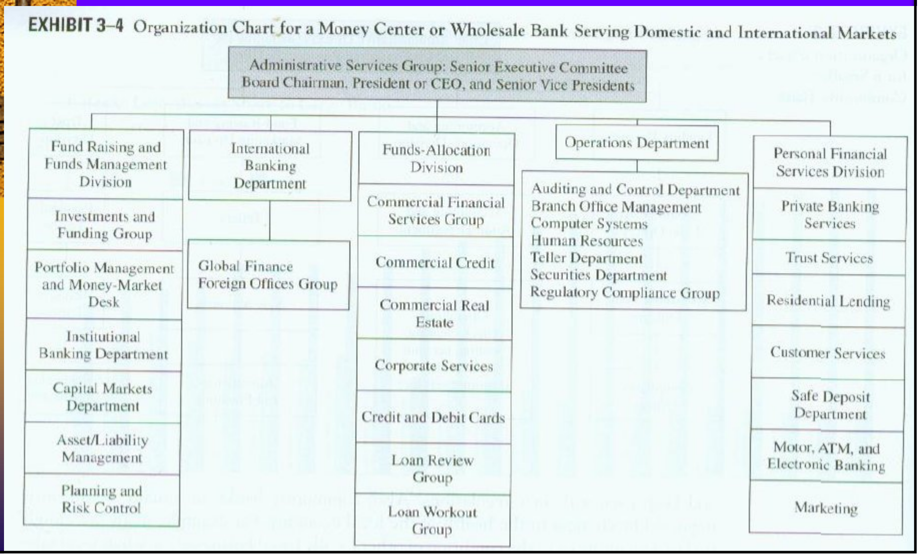
Holding Company Organizations

- Why holding companies have grown
+ Their greater access to capital markets in raising funds
+ Their ability to use higher leverage than nonaffiliated financial firms
+ Their ability to expand business into outside banking

Holding Company Organizations

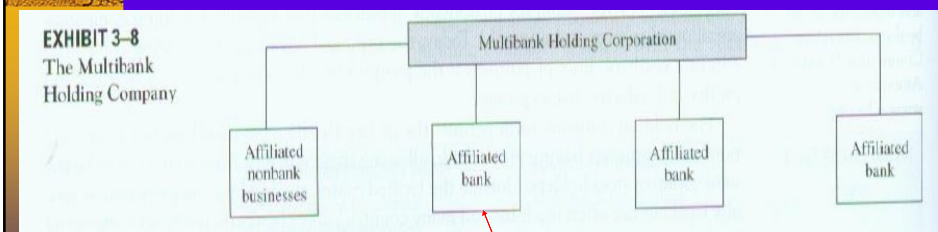
- One-Bank Holding Companies:
+ Most registered bank holding companies in the US
+ Controlling one or more nonbank businesses
+ See the blow exhibit

Holding Company Organizations



Holding Company Organizations

- Multibank Holding Companies: a minority of bank holding companies



Banks acquired by holding companies (>< independent banks)

Holding Company Organizations

- Advantages :
  + Holding firms tend to be more profitable
  + Failure rate for holding company banks lower than that of independent banks
- Disadvantages:
  + Reducing competition
  + Overcharging customers

Interstate banking

- Reasons:
  + More capital needed for local economies
  + Advances in technology
  + Nonbank financial institutions face restrictions to expand nationwide
  + Strong desire on the part of the largest financial firms
  + Market concentration

The Riegle – Neal Act 1994

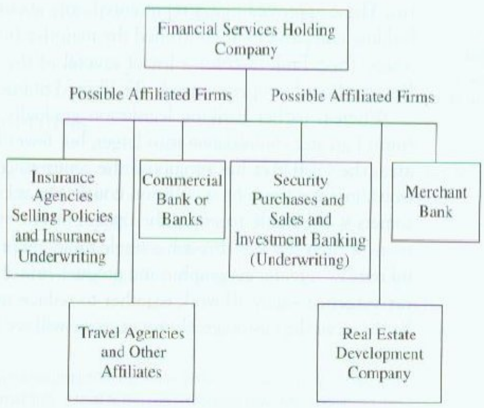
- Allows holding companies to acquire banks and establish branch offices cross the state
- Stated that no institutions can hold more than 10% of the nation’s deposits and no more than 30% of the state’s deposits

An Alternative Type of Banking Organization - Financial Holding Companies (FHCs)

- The 1999 Gramm-Leach-Bliley Act in the US created universal banking, in which banks merged with insurers or security firms
- The Law allows FHCs offering the broadest range of financial services (trading securities, insurance)

An Alternative Type of Banking Organization - Financial Holding Companies (FHCs)

EXHIBIT 3–9
The Financial Holding Company (FHC)



An Alternative Type of Banking Organization - Financial Holding Companies (FHCs)

- Each affiliated firm has its own capital, management, and seperated profit or loss
- This may reduce risk in financial services and better serve the customer

Mergers and Acquisitions Reshaping the Structure and Organization of the Financial-Services Sector

- Since 1980, there are more than 12000 bank mergers in the US
- Most of the acquired firms are converted into branches, affiliates or subsidiaries of the acquiring firm

The Changing Organization

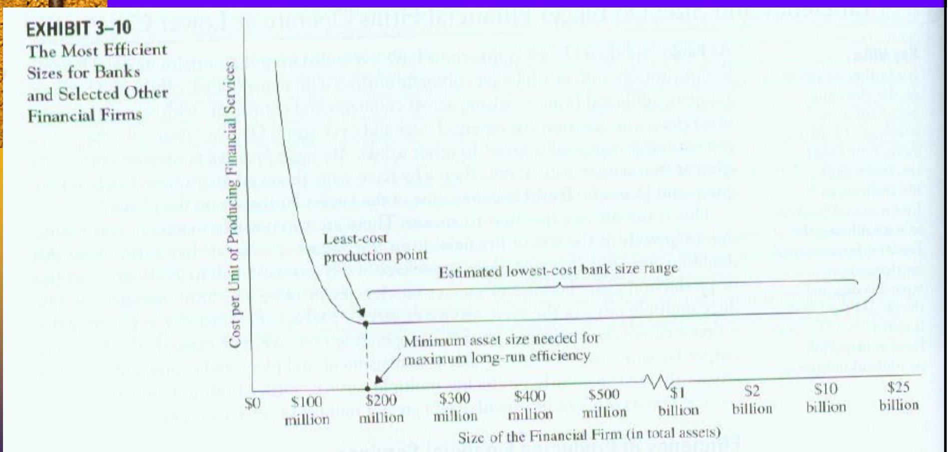
- Bank’s principal competitors:

+ Insurance firms
+ Credit unions
+ Savings associations
+ Finance companies
+ Investment/hedge funds
+ Security dealers

The Changing Organization

- Consolidation also occured for bank’s top competitors
- Convergence happened in financial firms. Insurance companies can buy banks for cross-selling banking/insurance services

Efficiency in producing financial services



Financial firm goals: Operating cost, Efficiency and Performance

- Expense- preference behavior

+ Some management prefer to form a larger staff and cause expenses out of control
+ Management have more opportunity to decide more benefits for managers

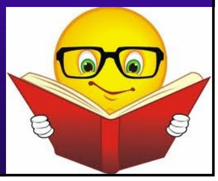
Financial firm goals: Operating cost, Efficiency and Performance

- Agency theory:
- To reduce this cost:

+ Develop a mangement monitoring system
+ Create a better corporate governance
+ Use labor efficient and capital market to eliminate bad managers

Summary

- Before the crisis 2007-2009, there is a rise of branching, bank holding companies (BHC) and FHCs.
- Financial firms changed from unit (single office) firms to more complex branching organizations with multiple offices and ultimately the FHCs acquiring stocks of financial service firms.



Multiple Choice Question

1. Economies of scale means doubling output products will result in less than a doubling of production costs due to greater efficiencies in using the firm’s resources to produce multiple units of the same product :

a. True

b. False

Multiple Choice Question

2. Economies of scope means that fixed costs can be spread over a greater number of service outputs:

a. True

b. False

MCQ-Answers

1. A
2. A

MCQ

- 1. A(n) ____________________ is a machine located at the merchant's place of business which allows depositors to use their debit card to pay for purchases directly.

- 2. A(n) ______________________ is a bank which offers its full range of services from several locations.

MCQ

- 3. A(n) ______________________ is a bank which offers its full range of services from only one location.

MCQ

- 4. A(n)_________________________ is a corporation chartered for the express purpose of holding the stock of one or more banks.

- 5. Managers who value fringe benefits, plush offices and ample travel budgets over the pursuit of maximum returns for stockholders are exhibiting signs of ___________________________.

MCQ-Answers

1. Answer: POS
2. Answer: branch bank
3. Answer: unit bank
4. Answer: Bank Holding Company
5. Answer: Expense Preference Behavior

MCQ

1. The ________________________ was created as part of the Glass Steagall Act. In the beginning it insured deposits up to $2,500.
2. The ___________________________ prevented banks from crossing state lines and made national banks subject to the branching laws of their state. This act was later repealed by the Riegle Neal Interstate Banking law.
3. The____________________________ was created in 1913 in response to a series of economic depressions and failures. Its principal role is to serve as the lender of last resort and to stabilize the financial markets.