

# Introduction to U.S. Banks and Financial Institutions

Federal Reserve Bank of New York

Central Banking Seminar  
Preparatory Workshop in Financial Markets,  
Instruments and Institutions

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# Figure 1: Flow of Funds Through the Financial System

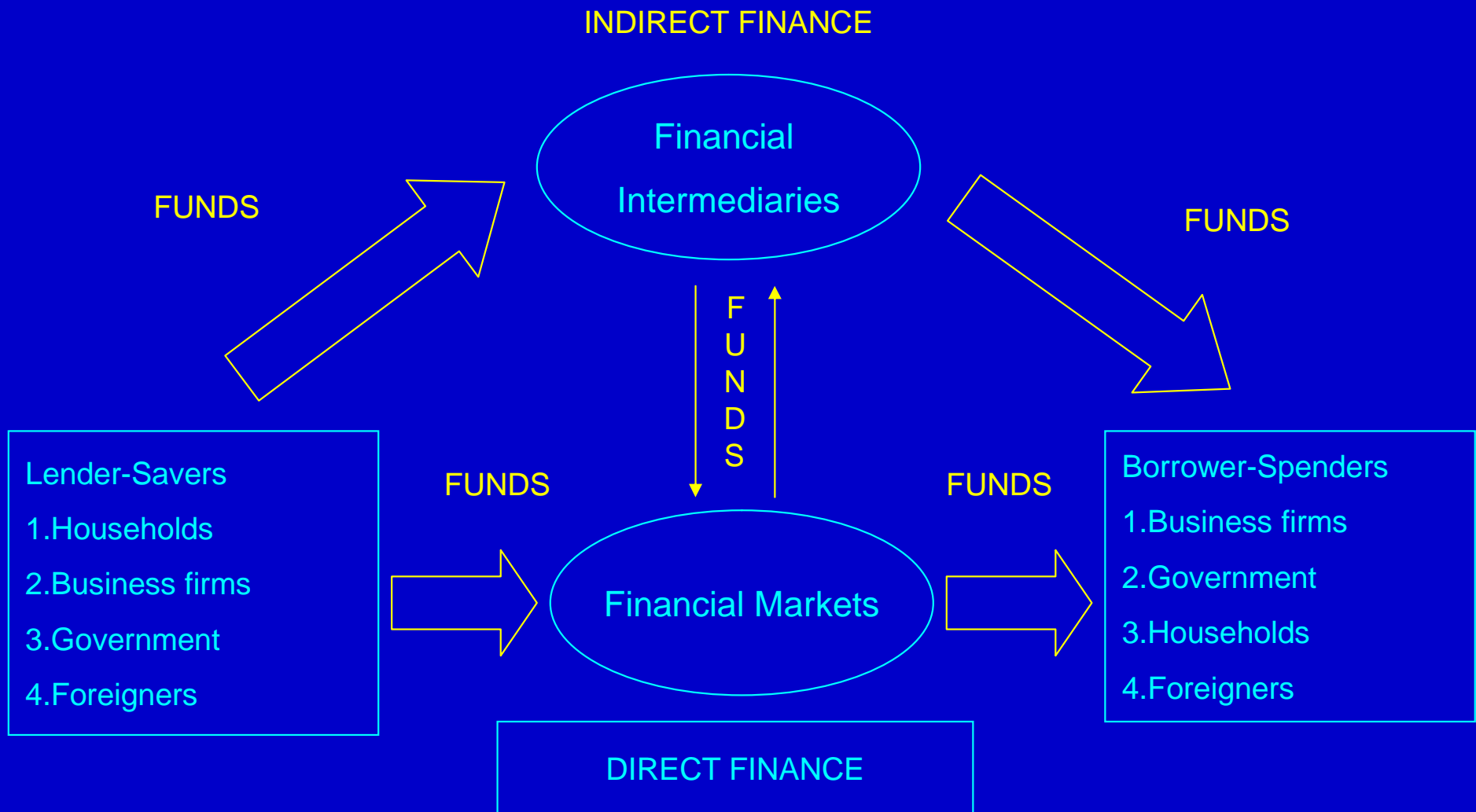
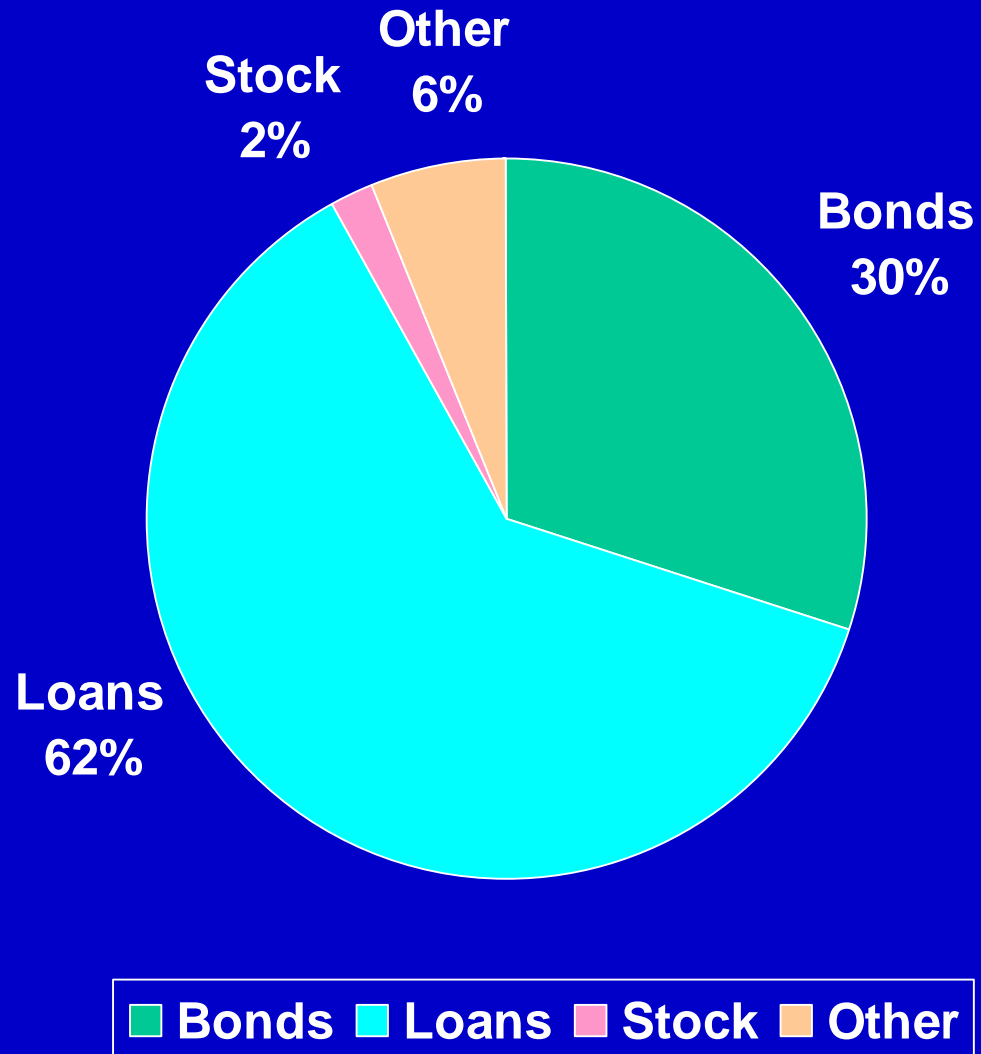


Figure 2: Sources of External Funds for Non-Financial Businesses



## Direct and Indirect Finance

- Indirect external finance (that is, loans) is more important than direct finance (stocks and bonds)
- Generally, loans are the most important source of financing in most developed (and developing) economies.

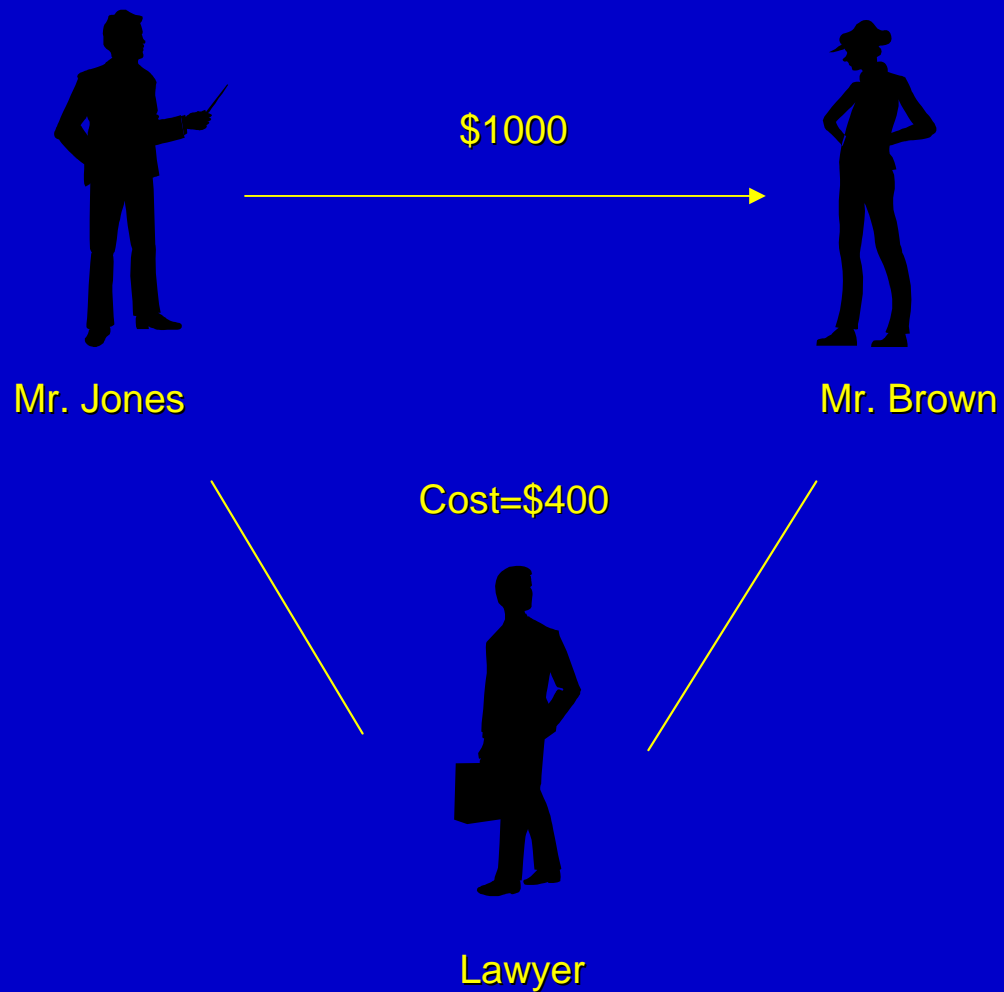
## Outline of Presentation

- Examine why financial intermediaries are so important in today's financial system
- Overview of financial intermediaries in United States
- Briefly, discuss the regulation of financial intermediaries

## Reasons for Financial Intermediaries

- Transaction Costs
  - A direct saver-to-borrower venue may be too costly, if the saver is to be guaranteed a full return in the investment
  - Financial intermediaries have the advantage of economies of scale and know how/expertise

## Figure 3: Transaction Cost of Direct Finance



# Incompatible Incentives Between Borrowers and Lenders

## 1. Asymmetric information

- Adverse selection (before loan is given)
- Moral hazard problems (after the loan is given)

## 2. Adverse Selection

- The lemons problem in a used-car market
- Same principle, holds in bond and equity markets

Conclusion: For these market to work, we typically need to have a dealer/broker or intermediary

## Ways to Alleviate Adverse Selection

- Generate information
  - Free-rider problems
- Regulation
  - In the U.S. the SEC (Securities and Exchange Commission) requires firms to:
    - Release company information
    - Follow accounting rules
- Rely on financial intermediaries
  - Create private information
- Require collateral/equity capital

## Moral Hazard / Principal-Agent Problem

Managers=Agents

Stockholders=Principals

- Different incentives
  - Managers may prefer higher pay/benefits
  - Stock owners: higher stock prices

## Ways to Alleviate Moral Hazard

- Monitoring
  - Credit rating agencies evaluate large firms
- Regulation
  - Reporting requirements
- Structured debt contracts
  - covenants that put limits, lower risks (insurance)
- Financial Intermediaries
  - venture capital firms that keep tight control
- Align incentives of agents and principals
  - Give managers some ownership

Table 1: Major Financial Intermediaries

Type of Intermediary	Primary Liabilities	Primary Assets
<p><b>Depository institutions</b></p> <ul style="list-style-type: none"> <li>• Commercial Banks</li> </ul>	Deposits	Loans (to consumers, business, mortgages, government securities, and other bonds)
<ul style="list-style-type: none"> <li>• Savings and Loan Associations</li> <li>• Credit Unions</li> <li>• Mutual Savings Banks</li> </ul>	Deposits Deposits Deposits	Loans (primarily mortgages) Loans (primarily to members) Loans (primarily mortgages)

Table 1: Major Financial Intermediaries

Type of Intermediary	Primary Liabilities	Primary Assets
<p><b>Contractual savings institutions</b></p> <ul style="list-style-type: none"> <li>• Life Insurance Cos.</li> <li>• Fire and casualty insurance</li> <li>• Pension Funds, government retirement funds</li> </ul>	<p>Premiums from policies</p> <p>Premiums from policies</p> <p>Employee or employer contributions</p>	<p>Corporate bonds and mortgages</p> <p>Municipal bonds, corporate bonds, stocks, government securities</p> <p>Bonds and equity</p>

Table 1: Major Financial Intermediaries

Type of Intermediary	Primary Liabilities	Primary Assets
<b>Investment intermediaries</b>		
• Mutual funds	Shares	Equity and bonds
• Money market mutual funds	Shares	Money market instruments
• Finance companies	Commercial paper, equity and bonds	Loans (consumers and business)

Table 2. Assets of Financial Intermediaries (\$ billions)

	1980Q4	1990Q4	2003Q3
Commercial Banks	1481.72	3337.48	7624.10
Savings Institutions	792.38	1323.03	1437.12
Credit Unions	67.62	217.24	609.37
Bank Personal Trusts and Estates	244.80	522.14	824.27
Life Insurance Companies	464.18	1351.44	3579.25
Other Insurance Companies	182.10	533.47	976.31
Private Pension Funds	513.03	1626.75	3802.32
State and Local Govt. Retirement Funds	196.56	800.58	2104.88

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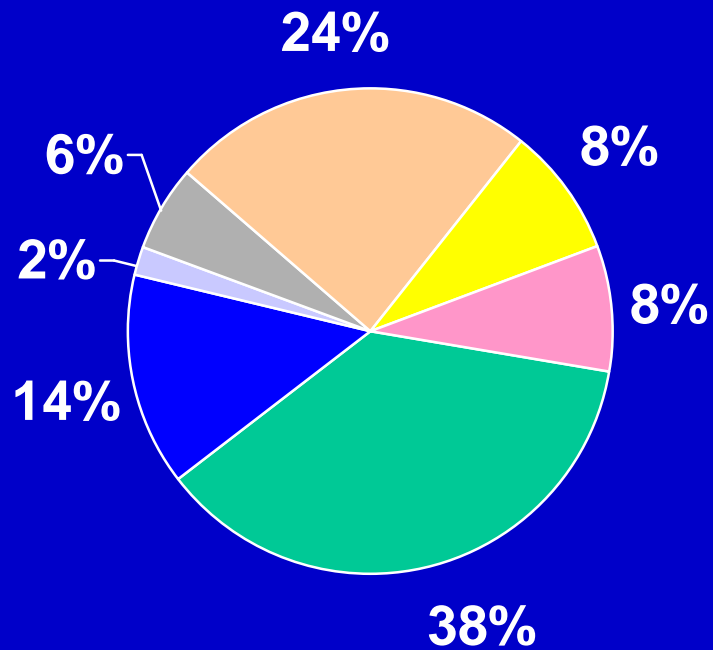
	1980Q4	1990Q4	2003Q3
Money Market Mutual Funds	76.42	493.32	2120.79
Mutual Funds	61.81	608.36	4072.60
Closed-End Funds	7.92	52.88	170.27
REITs	3.23	28.47	100.97
Brokers and Dealers	45.36	262.13	1502.31
Government-Sponsored Enterprises	195.14	477.60	2658.15
Federally Related Mortgage Pools	113.96	1019.86	3288.97
ABS Issuers	0.00	269.86	2511.56
Finance Companies	196.91	546.96	1244.94
Mortgage Companies	16.14	49.16	32.09

## Table 3. Balance Sheet of all US Commercial Banks, 2003

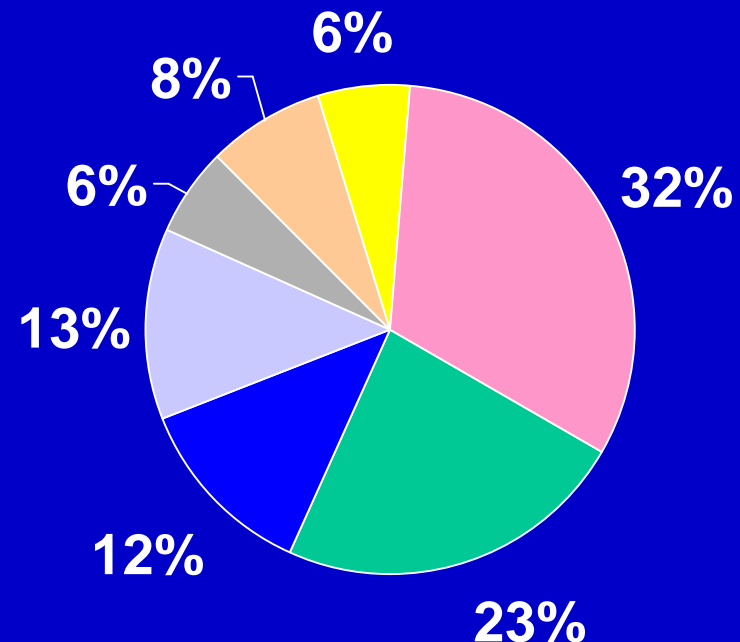
### Balance Sheet of all US Commercial Banks, 2003

Assets	Billions of \$	% of Assets	Liabilities	Billions of \$	% of Assets
Bank credit	6194.4	84.73	Deposits	4775.7	69.96
Securities in bank credit	1778.9	24.33	Transaction	634.8	9.30
U.S. government securities	1060.6	14.51	Nontransaction	4140.9	60.66
Other securities	718.3	9.83	Large time	1041.6	15.26
Loans and leases in bank credit	4415.5	60.40	Other	3099.3	45.40
Commercial and industrial	910.6	12.46	Borrowings	1481.2	21.70
Real estate	2255.4	30.85	From banks in the U.S.	403.2	5.91
Revolving home equity	258.4	3.53	From others	1078.1	15.79
Other-Mortgages	1997.0	27.32	Net due to related foreign offices	130.7	1.91
Consumer	602.0	8.23	Other liabilities	439.2	6.43
Security	202.2	2.77	<b>Total Liabilities</b>	<b>6826.8</b>	
Other loans and leases	445.3	6.09			
Interbank loans	308.0	4.21	Residual (assets less liabilities)	483.6	
Cash assets	331.0	4.53			
Other assets	552.9	7.56			
<b>Total Assets</b>	<b>7310.4</b>				

Figure 4: Assets of Financial Intermediaries



1980Q4



2003Q2

- |                         |           |
|-------------------------|-----------|
| Banks                   | Insurance |
| Investment Funds        | Financing |
| Thrifts & Credit Unions | Pensions  |
| Asset-Backed & GSEs     |           |

## Table 4: Regulatory Agencies of the U.S. Financial System

Financial Institution	Regulatory Agency	Nature of Regulation
<p><b>Depositories</b></p> <ul style="list-style-type: none"> <li>Commercial Banks</li> </ul>	<p>National Banks: Office of the Comptroller of the Currency</p> <p>Bank Holding Companies: Federal Reserve</p> <p>State-Chartered Banks: State banking commissions</p> <p>All insured banks: Federal Deposit Insurance Corporation (FDIC)</p>	<p>Charter requirements, bank examination, capital requirements, restrictions on asset holdings, etc.</p>
<ul style="list-style-type: none"> <li>Credit Unions</li> </ul>	<p>National Credit Union Administration (NCUA)</p>	
<ul style="list-style-type: none"> <li>Savings and Loan</li> </ul>	<p>Office of Thrift Supervision (OTS)</p>	

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Financial Institution	Regulatory Agency	Nature of Regulation
<p><b>Contractual Savings Institutions</b></p> <ul style="list-style-type: none"> <li>• Insurance Companies</li> </ul>	<p>State insurance commissions. Indirectly the government through the Internal Revenue Service (IRS)</p>	<p>Licensing, examination, capital requirements, restrictions on asset holdings, branching restrictions.</p>
<ul style="list-style-type: none"> <li>• Pension Funds</li> </ul>	<p>Employ Retirement Security Act, 1974 (ERISA). Pension Benefit Guarantee Corporation.</p>	<p>Funding rules, transfer of benefits, minimum vesting requirements, disclosure.</p>
<p><b>Investment Intermediaries</b></p> <ul style="list-style-type: none"> <li>• Mutual Funds and MMMFs</li> </ul>	<p>Securities and Exchange Commission</p>	<p>Disclosure requirements, restrictions on soliciting business.</p>
<ul style="list-style-type: none"> <li>• Finance Companies</li> </ul>	<p>Usually subject to state regulation.</p>	<p>Bankruptcy laws, usury laws, transparency rules</p>

## Major Events in Financial Regulation

- 1933 Glass Steagall Act
  - Barred commercial banks from most securities activities
- 1956 Bank Holding Act
  - Fed regulates multi-bank holding companies
- 1980 Depository Institutions Deregulation and Monetary Control Act
  - NOW deposit accounts, eliminates interest rate controls
- 1982 Garn-St Germain Act
  - Broadens Thrift powers and activities

## Major Events in Financial Regulation

- 1980s Financial institutions begin to chip at regulatory restrictions
  - Sect. 20 subs, CMAs, underwriting
- 1989 Financial Institutions Reform and Recovery Act
  - Fixes Thrift problems
- 1994 Riegle-Neal Interstate Banking Act
  - Banks are allowed to branch nationwide

## Major Events in Financial Regulation

- 1999 Gramm-Leach-Bliley Act
  - Allows for Financial Holding Companies (FHC). FHC subsidiaries can participate in banking, insurance, and securities businesses
  - SEC, Federal Reserve, and other regulatory agencies keep oversight
  - Enacts new privacy protection rules
  - Consumer protection: “anti-tying” provisions, enhances CRA lending