



Module: English

Branch: Finance and International Trade

Level: Third year Bachelor

Lecture 05: Conventional Banking

Conventional Banking plays a vital role in directing funds towards borrowers who have promising investment opportunities. This financial function is crucial for maintaining the smooth and efficient operation of both the financial system and the broader economy.

Objectives

After completing this unit, you should be able to:

- Explain what a commercial bank is
- Identify the key components of a commercial bank's balance sheet

1. Introduction

Financial intermediaries can be grouped into three main categories: depository institutions (commonly referred to as banks), contractual savings institutions, and investment intermediaries. Depository institutions, which we will generally call banks in this text, are entities that accept deposits from both individuals and organizations and use those funds to provide loans. The study of money and banking emphasizes these institutions because they are instrumental in generating deposits, a major part of the money supply. This category includes commercial banks as well as thrift institutions such as savings and loan associations, mutual savings banks, and credit unions.

Type of Intermediary	Primary Liabilities (Sources of Funds)	Primary Assets (Uses of Funds)
Depository institutions (banks) Commercial banks Savings and loan associations Mutual savings banks Credit unions	Deposits Deposits Deposits Deposits	loans, mortgages, U.S. government securities, bonds Mortgages Mortgages Consumer loans
Contractual savings institutions Life insurance companies Fire and casualty insurance companies Pension funds, government retirement funds	Premiums Premiums Contributions	Corporate bonds and mortgages bonds, and stock, and U.S. government securities Corporate bonds and stock
Investment intermediaries Finance companies Mutual funds Money market mutual funds Hedge funds	Commercial paper, stocks, Shares Shares Partnership participation	Consumer and business loans Stocks, bonds Money market instruments Stocks, bonds, loans

Source; -Frederic S. Mishkin. *The economics of money, Banking and financial markets* . Thirteenth Edition Pearson Education Limited 2022.P87

2- What is a Commercial Banks?

Commercial Banks These financial intermediaries raise funds primarily by issuing checkable deposits (deposits on which checks can be written), savings deposits (deposits that are payable on demand but do not allow their owners to write checks), and time deposits (deposits with fixed terms to maturity). They then use these funds to make commercial, consumer, and mortgage loans.

3- The Bank Balance Sheet

To understand how banking works, we start by looking at the bank balance sheet.

A-Liabilities

A bank acquires funds by issuing (selling) liabilities, which are the *sources of funds* the bank uses. The funds obtained from issuing liabilities are used to purchase income-earning assets.

-Checkable Deposits; Checkable deposits are bank accounts that allow the owner of the account to write checks to third parties. Checkable deposits include all accounts on which checks can be drawn.

-Nontransaction Deposits; Nontransaction deposits are the primary source of bank funds. There are two basic types of nontransaction deposits: savings accounts and time deposits.

Savings accounts were once the most common type of nontransaction deposit. Funds can be added to or withdrawn from savings accounts at any time. Time deposits have a fixed maturity length, ranging from several months to over five years, and assess substantial penalties (the forfeiture of several months' interest) for early withdrawal of funds.

-Borrowings; Banks also obtain funds by borrowing from the central bank, other banks, and corporations. Borrowings from the central bank are called discount loans (also known as *advances*). Banks also borrow from funds market from .Other sources of borrowed funds are loans made to banks by their parent companies (bank holding companies), loan arrangements with corporations (such as repurchase agreements), and borrowings of Eurodollars (deposits denominated in U.S. dollars residing in foreign banks or foreign branches of U.S. banks)..

-Bank Capital; The final category on the right-hand side of the balance sheet is bank capital, or the bank's net worth, which equals the difference between total assets and liabilities. Bank capital is raised by selling new equity (stock) or from retained earnings. A bank's capital is its cushion against a drop in the value of its assets, which could force the bank into insolvency, which occurs when a bank has liabilities in excess of assets, meaning that the bank can be forced into liquidation.

B-Assets

A bank uses the funds that it has acquired by issuing liabilities to purchase income-earning assets. Bank assets are thus naturally referred to as *uses of funds*, and the interest payments earned on them are what enable banks to make profits.

-Reserves; All banks hold some of the funds they acquire as deposits in an account at the central bank. Reserves consist of these deposits plus currency that is physically held by banks (called vault cash because it is stored in bank vaults overnight). Although reserves earn a low interest rate, banks hold them for two reasons. First, some reserves, called required reserves, are held because of reserve requirements,. Banks hold additional reserves, called excess

reserves, because they are the most liquid of all bank assets and a bank can use them to meet its obligations when funds are withdrawn,

either directly by a depositor or indirectly when a check is written on an account.

-Cash Items in Process of Collection; Suppose that a check written on an account at another bank is deposited in your bank, and the funds for this check have not yet been received (collected) from the other bank. The check is classified as a “cash item in process of collection,” and it is an asset for your bank because it is a claim on another bank for funds that will be paid within a few days.

-Deposits at Other Banks; Many small banks hold deposits in larger banks in exchange for a variety of services, including check collection, foreign exchange transactions, and help with securities purchases. This is one aspect of a system called *correspondent banking*.

-Securities A bank’s holdings of securities are an important income-earning asset: Securities (made up entirely of debt instruments for commercial banks. Banks hold state and local government securities because state and local governments are more likely to do business with banks that hold their securities.

-Loans; Banks make their profits primarily by issuing loans A loan is a liability for the individual or corporation receiving it but an asset for a bank, because it provides income to the bank. Loans are typically less liquid than other assets because they cannot be turned into cash until the loan matures. If a bank makes a one-year loan, for example, it cannot get its funds back until the loan comes due in

one year. Loans also have a higher probability of default than other assets. Because of their lack of liquidity and their higher default risk, the bank earns its highest return on loans.

-Other Assets; The physical capital (bank buildings, computers, and other equipment) owned by banks is included in the other assets category.

References;

-Frederic S. Mishkin. The economics of money, Banking and financial markets . Thirteenth Edition Pearson Education Limited 2022