SCHOOL OF BUSINESS AND ECONOMICS

DEPARTMENT OF MANAGEMENT

MANAGEMENT OF FINANCIAL INSTITUTIONS

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CHAPTER ONE

1. INTRODUCTION

A financial system is a highly integrated system which consists of markets, institutions rules; laws and regulations where by financial services are produced and delivered. In this chapter, we are going to focus on the basic concepts of the operations of a financial system and the clients of the same system. i.e. households, business firms and government. An overview about financial markets, financial securities as well as financial institutions will also be provided.

1.1. Introduction to Financial Institutions

A financial institution is an establishment that conducts financial transactions such as investments, loans and deposits. Almost everyone deals with financial institutions on a regular basis. Everything from depositing money to taking out loans and exchanging currencies must be done through financial institutions. Here is an overview of some of the major categories of financial institutions challenges in rural finance .

A financial institution is an establishment that conducts financial transactions such as investments, loans and deposits. Almost everyone deals with financial institutions on a regular basis. Everything from depositing money to taking out loans and exchanging currencies must be done through financial institutions. Financial institution focuses on dealing with financial transactions such as investment, loans and deposits. Almost everyone has deal with a financial institution on regular basis. Everything from depositing money to taking out loans and exchange currencies must be done.

How Financial Institutions Work

Financial institutions serve most people in some way, as financial operations are a critical part of any economy, with individuals and companies relying on financial institutions for transactions and investing. Governments consider it imperative to oversee and regulate banks and financial institutions because they do play such an integral part of the economy. Historically, bankruptcies of financial institutions can create panic.

In the United States, the Federal Deposit Insurance Corporation (FDIC) insures regular deposit accounts to reassure individuals and businesses regarding the safety of their finances with financial institutions. The health of a nation's banking system is a linchpin of economic stability. Loss of confidence in a financial institution can easily lead to a bank run.

Key Takeaways

- A financial institution (FI) is a company engaged in the business of dealing with financial and monetary transactions such as deposits, loans, investments, and currency exchange.
- Financial institutions encompass a broad range of business operations within the financial services sector including banks, trust companies, insurance companies, brokerage firms, and investment dealers.
- Financial institutions can vary by size, scope, and geography.

1.2. Meaning and nature of financial institutions

Most financial institutions (commercial banks, investment banks, savings and loans, credit unions, insurance companies, hedge funds, pension funds, etc.) act as intermediaries between borrowers and lenders who have different objectives. In general, most lenders wish to lend for a shorter period of time and in smaller amounts than borrowers wish to borrow. You can see how this works by looking at a commercial bank.

When you put money in a checking account you are in effect lending the bank a small amount of money for a short period of time—the amount of money you deposit and the time you leave it there until you write a check. The bank takes the small amounts of money its depositors lend for this short period of time and makes larger loans to its borrowers for a longer period of time, say, tens or hundreds of thousands of dollars for 90 days or six months. They can do this because in normal times depositors deposit money in their accounts at more or less the same rate they take money out so even though the balances of individual accounts change rapidly and dramatically the total amount of deposits available to the bank to lend is relatively stable. When times are not normal, however, banks and other financial institutions can get into trouble.

There are two ways a financial institution (or any business or firm for that matter) can get into trouble. One is if the value of its assets (those things that the institution owns) is less than the value of its liabilities (those things that the institution owes to others). Even in normal times this is a serious problem for a financial institution because it means that the institution's net worth (the difference between the value of what it owns, i.e., its assets, and what it owes, i.e., its liabilities; net worth is also referred to as net or owner's equity or capital) is negative. In this situation the financial institution is insolvent, and even if it liquidates (sells) all of its assets it will not be able to pay all that it owes to others. When a financial institution is insolvent it is in real trouble and is in danger of being forced to close its doors.

The other way a financial institution can get into trouble is if it has a liquidity or cash flow problem. When there is a net cash flow out of a financial institution this generally means its financial obligations to others are coming due, and it must meet these obligations with cash. If it doesn't have cash available to meet these obligations, for example to meet its payroll or make a payment on a loan it will default on its payments and, again, is in danger of being forced out of business. When financial institutions do not have enough cash on hand to meet their obligations they must either borrow money (hence, keep their total liabilities from falling by creating a new liability) or, if necessary, they must sell off some of their assets to obtain the cash they need.

In normal times the financial system as a whole is able to handle the liquidity and solvency problems of individual institutions with relative ease, but there is a vulnerability that is inherent in the very nature of financial institutions (and to some extent in the nature of most businesses and firms) that arises from the fact that, in general, their assets have a longer term to maturity than do their liabilities. You can see how this works in your bank.

Your deposit is a short-term loan to your bank that it owes to you and hence is its liability. The bank makes a loan with the money it gets from you for a specific period of time in the future, say 90 days, and this loan becomes its asset, something the bank owns. The bank’s loan from you is on demand, that is, its term to maturity (period of time until the date your loan matures and your bank must pay it back to you) is zero since the bank must pay back your loan at your demand while the term to maturity of the loan the bank makes is 90 days.

This means that the very existence of a financial institution depends on the confidence lenders have in the institution. If lenders lose confidence in an institution, new lenders will refuse to lend to it, and old lenders will refuse to renew their loans when they come due. In the case of your bank, new depositors will choose other banks, and old depositors will close their accounts. In this situation your bank will be forced to pay out cash to pay off its depositors, and when it can’t get the cash from new depositors it will be forced to liquidate its assets by selling them off to meet the demands of its depositors. It will be forced out of existence if it is insolvent in this situation, that is, if its net worth is negative. What's more, even if it is solvent before depositors lose confidence in it, it can be made insolvent after depositors lose confidence if it is forced to sell off its assets at fire-sale prices that are below what its assets are actually worth.

This inherent vulnerability to the confidence of lenders not only applies to individual financial institutions; it extends to the financial system itself. The reason is financial institutions are interconnected and interdependent in innumerable ways. To a very large extent the assets and liabilities of one financial institution are the liabilities and assets of other financial institutions. When you deposit money in your bank the bank agrees to pay you back the principal plus interest (if any) on the terms the bank sets for your account. That deposit is your asset, something you own, and the bank's liability, something it owes. Your bank takes your money, combines it with the money of other depositors, loans the money to someone to buy a house and takes a mortgage on the house which becomes your bank's asset and the homeowner's liability. Your bank then sells the mortgage to an investment bank and it becomes the investment bank's asset and the money your bank gets from the investment bank becomes its asset which it can use to make more loans.

The investment bank combines the mortgage it got from your bank with mortgages it got from other banks and uses these mortgages as collateral for Mortgage Backed Securities (MBSs). These securities (mortgage bonds) are given a rating by a credit rating agency (such as Standard and Poor's, Moody's, or Fitch Ratings) and are then sold to other financial institutions such as pension funds and insurance company—perhaps, even to your pension fund or life insurance company or the pension fund or insurance company of the mortgagee who borrowed the money in the first place.

At the same time the investment bank insures its mortgage assets against default by purchasing a Credit Default Swap (CDS) from a hedge fund or an insurance company.

1.3. Types of financial institutions

Financial institutions provide services as intermediaries of financial markets. Broadly speaking, there are three major types of financial institutions:

Depositary institutions – deposit-taking institutions that accept and manage deposits and make loans, including banks, building societies, credit unions, trust companies, and mortgage loan companies.

Financial institutions offer a wide range of products and services for individual and commercial clients. The specific services offered vary widely between different types of financial institutions.

Commercial Banks

A commercial bank is a type of financial institution that accepts deposits, offers checking account services, makes business, personal, and mortgage loans, and offers basic financial products like certificates of deposit (CDs) and savings accounts to individuals and small businesses. A commercial bank is where most people do their banking, as opposed to an investment bank.

Banks and similar business entities, such as thrifts or credit unions, offer the most commonly recognized and frequently used financial services: checking and savings accounts, home mortgages, and other types of loans for retail and commercial customers. Banks also act as payment agents via credit cards, wire transfers, and currency exchange.

Investment Banks

Investment banks specialize in providing services designed to facilitate business operations, such as capital expenditure financing and equity offerings, including initial public offerings (IPOs). They also commonly offer brokerage services for investors, act as market makers for trading exchanges, and manage mergers, acquisitions, and other corporate restructurings.

Insurance Companies

Among the most familiar non-bank financial institutions are insurance companies. Providing insurance, whether for individuals or corporations, is one of the oldest financial services. Protection of assets and protection against financial risk, secured through insurance products, is an essential service that facilitates individual and corporate investments that fuel economic growth.

Brokerage Firms

Investment companies and brokerages, such as mutual fund and exchange-traded fund (ETF) provider Fidelity Investments, specialize in providing investment services that include wealth management and financial advisory services. They also provide access to investment products that may range from stocks and bonds all the way to lesser-known alternative investments, such as hedge funds and private equity investments.

What Are Financial Institutions?

If you have a part-time job or full-time job and a credit or debit card, you most likely have a customer relationship with a financial institution. Financial institutions are organizations that process monetary transactions, including business and private loans, customer deposits, and investments. They're key to the financial intermediation process, whereby financial institutions transfer funds from those who save money to those who borrow money. Let's take a look at the three main types of financial institutions: depository, non- depository, and investment.

Depository Institutions

Depository institutions allow customers to deposit money in an account. You're probably most familiar with these types of financial institutions if you have a checking or savings account. Examples of depository institutions include commercial banks and credit unions. Commercial banks are for-profit entities that provide a number of services to their account holders. These types of financial institutions usually operate at the local, regional or national level, have large advertising budgets, and charge higher fees than a credit union. Credit unions are non-profit entities owned by accountholders, also called members. You must be affiliated with a certain organization or live within a certain proximity to the credit union to be a member. Fees are usually lower at credit unions. They're typically found at the local level. It's relatively easy to understand how financial intermediation works at depository institutions because customers deposit money in accounts, and the institutions loan that money to borrowers. Now let's see how non-depository institutions play a role in this process.

1.4. Functions of financial institutions

Financial institutions provide services as intermediaries of financial markets. Broadly speaking, there are three major types of financial institutions. Financial institutions provide financing, facilitate economic transactions, issue funds, offer insurance and hold deposits for businesses and individuals. Financial institutions are private or public organizations that serve as an intermediary between savers and borrowers of funds. The two primary types of financial institutions are credit unions or depository banks and non-depository mutual funds and insurance companies. Banks and equity markets are the fundamental institutions in most financial systems.

Depository banks and credit unions provide private and commercial loans for individuals and businesses. These financial institutions also hold deposits and issue certificates for investments. Non-depository financial institutions, such as insurance companies, collect funds by selling policies or units to the public. These institutions provide returns to their investors in the form of benefits, dividends and/or profit payouts. Non-depository financial institutions are critical in mitigating risk for businesses and consumers.

Financial institutions fuel the economy by issuing credit, which comes in the form of loans, mortgages and credit cards, to allow individuals and businesses to purchase goods and services, homes, attend college, start a business, etc. Financial institutions also serve as direct providers of liquidity through demand deposits and credit lines.

Financial institutions, through processing transactions and purchasing and selling large volumes of securities, play a fundamental role in the equity markets. The functions of financial institutions, such as stock exchanges, commodity markets, futures, currency, and options exchanges are very important for the economy. These institutions are involved in creating and providing ownership for financial claims. These institutions are also responsible for maintaining liquidity in the market and managing price change risks. As part of their various services, these institutions provide investment opportunities and help businesses to generate funds for various purposes.

The functions of financial institutions like investment banks are also vital and related to the investment sector. These companies are involved in a number of financial activities, such as underwriting securities, selling securities to investors, providing brokerage services, and fundraising advice. More Information Related to Financial Institutions

Banks	**Credit Unions**
Indian Financial Institutions	Stock Brokerage
Community Development	Institutional Compliance
Financial Institutional Fraud	Financial Institutional Functions
Financial Institution Management	Financial Institution Ratings
Financial Institutional Regulation	Risk Management
International Role of Financial Institution	Stock Exchange
Trust Company	Financial Institution Valuation
Types of Financial Institutions	Financial Institutional Security
Marketing in Financial Institution	Financial Institutional Insurance

1.5. Role of Financial Institutions

A **financial institution** is an establishment that conducts financial transactions such as investments, loans and deposits. Almost everyone deals with financial institutions on a regular basis. Everything from depositing money to taking out loans and exchanging currencies must be done through financial institutions. Here is an overview of some of the major categories of financial institutions and their roles in the financial system. Financial institutions include banks, credit unions, asset management firms, building societies, and stock brokerages, among others. These institutions are responsible for distributing financial resources in a planned way to the potential users.

There are a number of institutions that collect and provide funds for the necessary sector or individual. On the other hand, there are several institutions that act as the middleman and join the deficit and surplus units. Investing money on behalf of the client is another of the variety of functions of financial institutions.

Financial institutions can be categorized as follows:

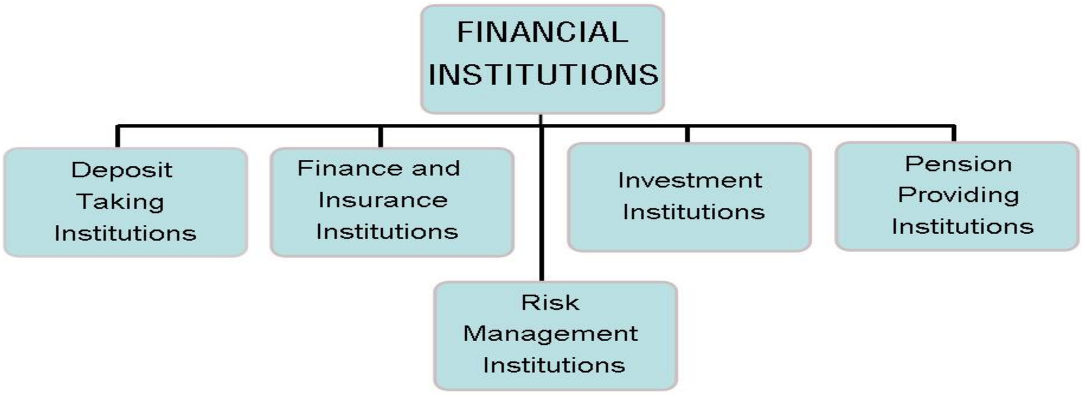
1. Deposit Taking Institutions
2. Finance and Insurance Institutions
3. Investment Institutions
4. Pension Providing Institutions
5. Risk Management Institutions

At the same time, there are several governmental financial institutions assigned to regulatory and supervisory functions. These institutions have played a distinct role in fulfilling the financial and management needs of different industries, and have also shaped the national economic scene. Deposit-taking financial organizations are known as commercial banks, mutual savings banks, savings associations, and loan associations and so on.

Role of Financial Institutions:

The primary functions of financial institutions of this nature are as follows:

- Accepting Deposits
- Providing Commercial Loans
- Providing Real Estate Loans
- Providing Mortgage Loans
- Issuing Share Certificates



Finance companies provide loans, business inventory financing and indirect consumer loans. These companies get their funds by issuing bonds and other obligations. These companies operate in a number of countries. On the other hand, there are insurance companies that provide coverage for a variety of risk factors and they also provide several investment options. Insurance companies provide loans for a number of purposes and create investment products.

In this first chapter we want to identify a preliminary answer to two questions. We want to know what is meant by the expression the "financial system" and we want to know what such a system does. For the purposes of this book, we shall define a financial system, fairly narrowly to consist of a set of markets, individuals and government responsible for their regulation. The end users of the system are people and firms whose desire is to lend and to borrow.

Filled with a desire to lend or to borrow the end users of most financial systems are faced with a choice between three broad approaches. Firstly, they may decide to deal directly with another, through this, as we shall see, is costly, risky, inefficient, consequently; and not very likely. More typically, they may decide to use one or more of many organized markets. In these markets, lenders buy the liabilities issued by the borrowers. If the liability is newly issued, then the issuer receives funds directly from the lender. More frequently, however, a lender will buy an existing liability from another lender. In effect, this refinances the original loan though the borrower who is completely unaware of this secondary transaction. The best known markets are the stock exchanges in major financial and non-financial firms. The choice between dealing directly, dealing through intermediaries and dealing through markets is summarized in figure 1.1

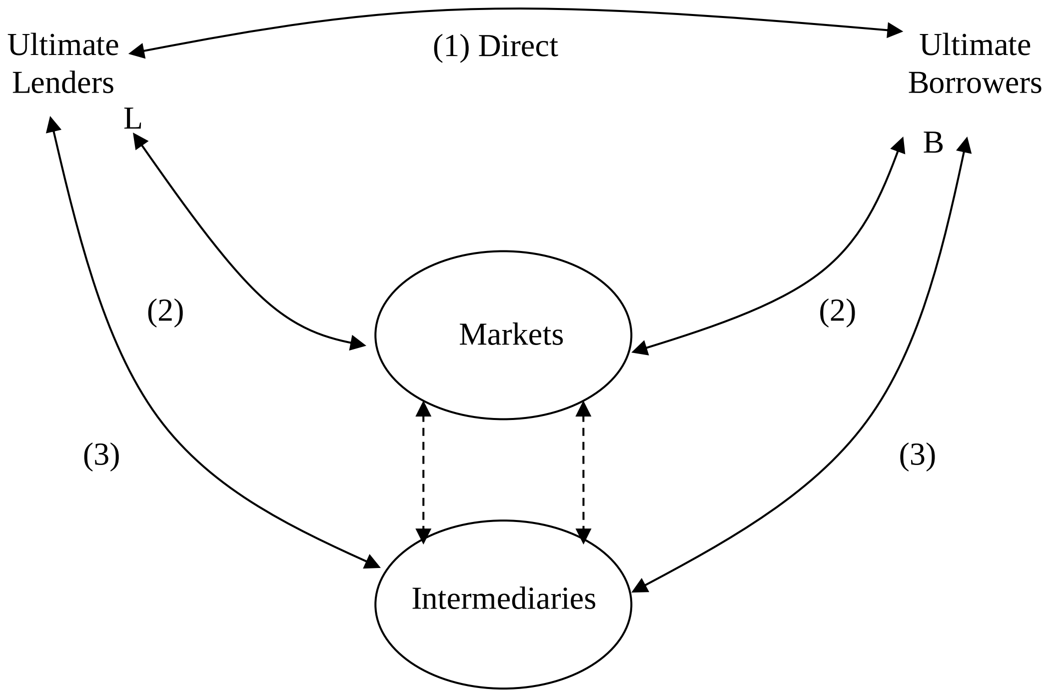


Figure 1:1

Alternatively, borrowers and lenders may decide to deal via intermediaries. In this case, lenders have an asset – a bank deposit or contribution to a life insurance or pension fund – which cannot be traded but can only be returned to the intermediary. Similarly, intermediaries create liabilities, typically in the form of loans, for borrowers. These remain in the intermediaries balance sheets until they are repaid. Intermediaries themselves will also make use of markets, issuing security to finance some of their activities and buying shares and bonds as part of their asset portfolio.

Helping funs to flow from lenders to borrowers is a characteristic of most components of the financial system. However, there are a number of functions, each of which tends to be associated with a particular part of the system.

For example, the financial system usually provides a means of making payments. In most cases this is the responsibility of deposit taking institutions (or a subset of them). Such institutions are usually members of a network (a clearing system) and accept instructions from their clients to make transfers of deposits to the accounts of clients. Traditionally this was done by issuing a paper instruction (a cheque) but today it is done increasingly by electronic means.

We assume most people are risk-averse. That is they are prepared to make a payment (or sacrifice some income) in order to avoid uncertainty, especially if the uncertainty mean possibility of a serious loss. Amongst the non-deposit taking institutions this service is carried out by insurance companies. They allow people to choose the certainty of a slightly reduced current income (reduced by the premiums they pay) in exchange for avoiding a catastrophic loss of income (or wealth) if some accident should occur.

Pension funds, unit trusts and investment trusts all offer savers the opportunity to accumulate a diversified portfolio of financial assets, though each does it in a slightly different way. Pension funds in particular help people to accumulate wealth over a long period and then to exchange this for income to cover the (uncertain) period between retirement and death.

Lastly, it should always be remembered that while savers may be building up a portfolio of wealth by acquiring financial assets, they want to be able rearrange that portfolio from time to time as they observe changes in the risk/return characteristics of the assets which they hold. If we use the phrase net acquisition to describe the additional assets that the household is able to add to its portfolio each year, we must remember that total purchase of assets may be much larger because there may also have been sales of some assets already in the portfolio as part of the portfolio adjustment process. A financial system must provide people with the means to make cheap and frequent adjustments to the portfolio of assets (and liabilities).

In this introductory chapter we shall look firstly at the institutions or intermediaries. Then, we turn our attention to financial markets and then we look at the end users of the system and at some of the motives and principles underlying their behavior. We can then appreciate some of the advantages that the end users obtain from the financial system.

1.5.1. Financial Institutions as firms

Financial institutions are firms and their behavior can be analyzed in much the same way that economists analyze any other type of firm. Thus, we can think of them as producing various forms of loans out of money which people are willing to lend.

Furthermore, we can assume that they are profit maximizes from charging interest to borrowers at a rate which exceeds that paid to lenders. One characteristic of most financial firms (though this still does not make them anything special) is they are large and therefore the profits are being maximized for shareholders rather than for entrepreneurs who themselves own and manage the firms. Like any other firm, profits will be maximized at the point where total revenue minus total costs is at its greatest, that is where the marginal revenue arising from an extra unit of output is just matched by the marginal cost of producing it. Also, quite conventionally, we can assume that the marginal cost of production is rising in the short term. Imagine, for simplicity, that a firms output consists of loans and that the major variable input is the deposits which it can attract from members of the public who are able to save. Other things being equal, it will only attract more deposits (than at present) with which to increase its production of loans, if it offers a higher rate of interest or better service (than at present). Whatever it does to get extra deposit, it is likely to cost more than was involved in getting the previous marginal business.

Making the assumption that financial firms are profit maximizes, however, does not mean that we have to think of financial firms operating according to the model of perfect competition. Financial firms tend to be large that this is because economics of scale are very common in the production of financial products. This has inevitably led, and continues to lead, to situations where some financial business is dominated by a few large organizations. In such cases we can observe many of the characteristics which oligopolistic theories of the firm will lead us to expect, for example, little apparent competition over prices, but a great deal of effort going into marketing and product differentiation.
We can move even further away from the model of perfect competition and still stay on fairly familiar ground. We can drop the assumption of profit maximization. There have been occasions in the recent past, particularly involving the major retail banks, when it has looked to outsiders as its decision have been made to pursue other objectives, at least in the short run. These other objectives might have been to increase market share at the expense of competitors, or to achieve a rate of growth (measured by the number of account holders) greater than that of their rivals obviously, level of profit has already been achieved and is reasonably secured, but it is quite different from rigorous profit maximization. Even so, this still leaves the behavior of financial firms looking very much like that of many other types of firms while it is important to bear in mind these similarities between financial and other types of firm, there is of course much that is distinctive about the business of financial firms: their products, and peoples reasons for buying the products; one different from those of manufacturing and retail firms. For example, the decision to buy on financial product offer involves making a judgment about events when might develop quite a long way in to the future. This is not necessary when buying goods for everyday consumption.

Furthermore, there are also significant differences between the products offered by financial firms' one distinction which is very commonly made, for example lies between deposit taking institutions (DTIs) and non-deposit taking institutions (NOTIS). Deposit taking institutions are organizations like banks and credit unions, whose liabilities (assets to lenders) are primary deposits. These can be withdrawn at short (sometimes zero) notice and usually form part of the national money supply. Non-deposit taking institutions are organizations like life assurance companies whose liabilities are promises to pay funds to savers only in response to a specified event. Unless the specified event occurs, it is very difficult to withdraw these funds and there is usually a considerable financial penalty for savers who do so. Similarity contributions to a pension fund cannot be easily withdrawn until the pension falls due for payment.

1.5.2. Financial Institutions as Intermediaries

Granted that financial institutions manufacture loans out of money which people lend, what else can we say about what they do? As a general rule, financial institutions are engaged in what is called intermediation. Rather obviously, intermediation means acting as a go-between for two parties. The parties here are usually called lenders and borrowers or sometimes surplus sectors or units and deficit sectors or units. What general principles are involved in this going between? The first thing to say is that it involves more than just bringing two parties together. One could imagine a firm which did this. It could keep a register of people with money to lend and a register of people who wished to borrow. Every day, people would join and leave each register and the job of the firm would be to scan the lists continuously, crying eureka (or something else of an appropriate kind) every time it found a potential lender whose desires matched those of a potential borrower. It would then charge a commission for introducing them to each other. Something else has to be provided. As a general rule what financial intermediaries do is: to create assets for savers and liabilities for borrowers which are more attractive to each than would be the case it the parties had to deal with each other directly.

1.5.3. Types of Financial Markets in the Financial System

A financial market is a market where financial assets are exchanged (i.e. traded). There are many ways to classify financial markets. One way is by the type of financial claim, such as debt markets and equity markets. Another is by the maturity of the claims. For example, there is a financial market for short-term debt instruments, called the money market, and one for longer maturity financial assets, called the capital market. Financial markets can be categorized as those dealing with financial claims that are newly issued, called primary market, and those for exchanging financial claims previously issued, called the secondary market, or the market for seasoned instruments. There is also the cash market and the derivative instrument market.

Finally, a market can be classified by its organizational structure. These organizational structures can be classified as action markets, over-the-counter-markets and intermediated markets. In an auction market there is bidding for financial assets. All trades of the financial asset take place in the centralized trading facility.

At one time, this centralized trading facility had to be a place where buyers and sellers, or their agents, called brokers, would gather to exchange financial claims for their customers. Brokers do not buy or sell for their own accounts, but in return for their services as agents, they relieve compensation called commissions. The auctioneer in an action market is called the market maker. Market makers may or may not take a position in the financial asset being traded, i.e. buy for or sell from their own accounts (inventory). When they do, the market maker is referred to as a dealer.

With the advances in computer technology, a physical facility that houses the centralized trading activities is unnecessary. The key is that all orders are executed in the centralized trading facility. The market consists of dealers who are willing to buy or sell the financial asset from or to any counter party. In contrast to action markets and over the counter markets in an intermediated market. In this market, an entity called financial intermediary issues financial claims against itself. With the funds it receives, it purchases financial assets. We shall discuss financial intermediaries latter in Chapter 2.

There are basic differences between a dealer and a financial intermediary. Unlike a dealer, a financial intermediary creates a claim against itself. A dealer simply buys and sells financial assets, smoothing out short-term price fluctuations. By contrast, typically a financial intermediary tries to hold the financial asset in order to achieve a desired long term asset/liability objective.

Market Participants

The participants in financial markets that issue and purchase financial claims include households, business entities (corporations and partnerships), the government and its agencies, (state and local governments, and foreign entities.) The last category includes foreign governments (called sovereigns), super national agencies (such as the World Bank and the Asian development bank), foreign corporations and individuals.

Finally, while we have focused on market participants who create under or exchange financial assets, a broader definition of market participants would include regulators of financial markets.

1.6. Summary

Financial institutions are organizations that process monetary transactions, including business and private loans, customer deposits, and investments.

A financial institution (FI) is a company engaged in the business of dealing with financial and monetary transactions such as deposits, loans, investments, and currency exchange.

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Financial institutions encompass a broad range of business operations within the financial services sector including banks, trust companies, insurance companies, brokerage firms, and investment dealers.

Financial institutions can vary by size, scope, and geography.

Types of financial institutions

- Commercial Banks Investment Banks
- Insurance Companies
- Brokerage Firms
- Depository Institutions

Financial institutions provide financing, facilitate economic transactions, issue funds, offer insurance and hold deposits for businesses and individuals**.** Financial institutions are private or public organizations that serve as an intermediary between savers and borrowers of funds. The two primary types of financial institutions are credit unions or depository banks and non-depository mutual funds and insurance companies. Banks and equity markets are the fundamental institutions in most financial systems.

Financial institutions can be categorized as follows:

- Deposit Taking Institutions
- Finance and Insurance Institutions
- Investment Institutions
- Pension Providing Institutions

Risk Management Institutions

The primary functions of financial institutions of this nature are as follows:

- Accepting Deposits
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A financial market is a market where financial assets are exchanged (i.e. traded). There are many ways to classify financial markets. One way is by the type of financial claim, such as debt markets and equity markets. Another is by the maturity of the claims. For example, there is a financial market for short-term debt instruments, called the money market, and one for longer maturity financial assets, called the capital market.

In this chapter, we have explained about financial assets and financial markets as well as financial institutions. The two principal economic functions of a financial asset are:

1) Transferring funds from those who have surplus funds to invest to those who heed funds to invest in tangible assets.
2) Transferring funds in such a way that redistributes the unavoidable risk associated with the cash flow generated by tangible assets among those seeking and those providing the funds.
3) Financial markets provide the following three additional functions beyond that of financial assets themselves:
4) They provide a mechanism for determining the price (or equivalently, the required return) of financial assets.
5) They make assets more liquid
6) They reduce the costs of exchanging assets. The costs associated with transacting are search costs and information costs.

There are various ways to classify financial markets:

Money (or short term) versus capital markets, debt versus equity markets, primary versus secondary markets, and cash versus derivative markets. Another classification is based on the type of organizational structure: auction versus over the counter versus intermediated market.

A financial system consists of a set of organized markets and institutions together with regulators of those markets and institutions. Their main function is to channel funds between end users of the system: from lenders (surplus units) to barrowers (deficit units). In addition, a financial system provides payments facilities, a variety of services like insurance, pensions and foreign exchange, together with facilities which allow people to adjust their existing wealth portfolios.

There are many advantages in borrowing and lending directly between end users. These include transforming the maturity of short term saving's into long term loans, together with the reduction of risk and transaction costs.

1.7. Exercise

I. True or False

1. Financial instruments are liabilities for savers but assets for borrowers.
2. Prices of financial assets in financial markets affect the financial and spending decisions of individuals and business and the efficiency of an economy.
3. Definitive money is money that does not have to be converted into a more basic legal medium of exchange.
4. Money markets are markets that trade debt and equity security.
5. A broker is a commissioned agent of a buyer (or a seller) who facilitates trade by locating a seller (or buyer) to complete the desired transaction
6. Dealers engage in asset transformation
7. Financial intermediaries typically hold financial assets as part of an investment portfolio rather than as an inventory for resale.
8. The initial issuer raises funds only through the primary market
9. An over-the counter market has centralized mechanism of or facility for trading.
10. The money-market is designed for the making of short-term loans
11. If we hold current output constant, a decrease in government purchases reduces national saving as long as house hold consumption falls less than one for one response.
12. In the financial system, savers provide funds to borrowers in return for promises of repayment of funds or even more funds in the future.

II. Multiple choices

13. A financial system:
   A. Creates liquidity and money
   B. Channels funds from lenders to borrowers
   C. All are answer
   D. Only A and B Are answer
14. Which of the following is not true about financial intermediation (or intermediaries)?

A. Intermediaries create assets for savers and liabilities for barrowers which are more attractive to each than would be the case if the parties had to deal with each other directly.
B. There will exist more financial assets and liabilities than would be the case if the community were to really upon direct lending.
C. With the intervention of intermediaries, lending and borrowing have become easier
D. All
E. None

15. Which of the following factors cannot be considered as a determinant of national saving?
   A. Current output
   B. Government purchases
   C. House hold consumption A and B
   D. None

16. Which of the following is false?
   A. When current income increases, both consumption and saving are likely to increase
   B. A drop in the real interest rate raises investment demand
   C. When the goods market is in equilibrium, national saving out weights national investment
   D. None

17. Which of the following is false about financial assets:
   A. Directly contribute to the productive capacity of an economy
   B. Appear on both sides of the balance sheet
   C. They are destroyed and created during the normal course of doing business.
   D. They define the allocation of income or wealth among investors.
   E. None

18. Which of the following is true?
   A. Financial markets do not efficiently match savers and borrowers when the transaction costs and information costs of lending are high
   B. Financial intermediaries take advantages of economics of scale by pooling savers' funds to lower transaction costs.
   C. Adverse selection is a difficulty in knowing the true prospects of the borrower before the transaction.
   D. Moral hazard represents the need to monitor the borrower's use of funds after the transaction.
   E. All
   F. Only C and D

19. Ultimate lenders:
    A. Are agents whose excess of income over expenditure creates a financial surplus?
    B. The usually take short position in the financial system
    C. Provide funds to the financial markets
    D. Includes households with savings
    E. All
    F. Only B, C and D
20. Which of the following can be the best possible arrangement of the characteristic of lenders and borrowers in the financial system?

Lenders		**Borrowers**
1.	→	high risk ....Low risk
Long term		Short term
Large amounts		Small amounts
2.	→	High risk...High risk
Long term		Long term
Large amounts		large amounts
3.	→	Low risk ....Low risk
Short term		Short term
Small amounts		Small amounts
4.	→	Low risk ....High risk
Short term		Long term
Small amounts		Large amounts

5. None
21. Real assets:
    A. Measure the material wealth of a society
    B. Directly contribute to the productive capacity of an economy
    C. Are income generating assets
    D. All
    E. None
22. Which of the following is false?
    A. Primary markets are securities markets in which newly issued securities are offered for sale to buyers.

B. Secondary markets are securities markets in which existing securities that have previously been issued are resold.
C. The money market is the market for short-term securities with one year or less remaining to maturity.
D. The capital market is the market for long-term securities, generally those with more than one year to maturity.
E. Financial intermediaries are financial institutions that engage in financial asset transformation.
F. None
G. A and D

Answers

Part I: True or False

.1.	False	.7.	True
.2.	True	.8.	True
.3.	True	.9.	False
.4.	False	.10.	True
.5.	True	.11.	False
.6.	False	.12.	True

Part II: Multiple chooses

1) D
2) E
3) E
4) C
5) A
6) E
7) E
8) D
9) D
10) F

CHAPTER TWO

2. BANKING SYSTEM

Introduction

Dear learner, when you sit back and think about it, banks are often a huge part of our lives. We deposit our paychecks, take out loans, and set up savings accounts, all at a bank. But what do banks do? What are the different types of banks? Let's start finding some answers to these questions by looking at the different types of banks that make up a banking system.

A banking system is a group or network of institutions that provide financial services for us. These institutions are responsible for operating a payment system, providing loans, taking deposits, and helping with investments.

Banking systems perform several different functions, depending on the network of institutions. For example, payment and loan functions at commercial banks allow us to deposit funds and use our checking accounts and debit cards to pay our bills or make purchases. They can also help us finance our cars and homes. By comparison, central banks or systems distribute currency and establish money-related policies. Investment banks or systems conduct trades or deal with capital markets. Many banks are profit-seeking entities with stockholders. They obtain profits by charging more interest for loans and paying less interest on deposits.

2.1. Central Banking System

What Is a Central Bank?

A central bank is a financial institution given privileged control over the production and distribution of money and credit for a nation or a group of nations. In modern economies, the central bank is usually responsible for the formulation of monetary policy and the regulation of member banks. Central banks are inherently non-market-based or even anticompetitive institutions. Although some are nationalized, many central banks are not government agencies, and so are often touted as being politically independent. However, even if a central bank is not legally owned by the government, its privileges are established and protected by law.

The critical feature of a central bank—distinguishing it from other banks—is its legal monopoly status, which gives it the privilege to issue bank notes and cash. Private commercial banks are only permitted to issue demand liabilities, such as checking deposits.

Key Takeaways

A central bank is an entity responsible for overseeing the monetary system and policy of a nation or group of nations, regulating its money supply and interest rates.

By easing or tightening the money supply and availability of credit, central banks seek to keep a nation's economy on an even keel.

A central bank sets requirements for the banking industry, such as the amount of cash reserves banks must maintain vis-à-vis their deposits.

A central bank can be a lender of last resort to troubled financial institutions and even governments.

Understanding a Central Bank

Although their responsibilities range widely, depending on their country, central banks' duties (and the justification for their existence) usually fall into three areas.

First, central banks control and manipulate the national money supply: issuing currency and setting interest rates on loans and bonds. Typically, central banks raise interest rates to slow growth and avoid inflation; they lower them to spur growth, industrial activity, and consumer spending. In this way, they manage monetary policy to guide the country's economy and achieve economic goals, such as full employment.

Second, they regulate member banks through capital requirements, reserve requirements (which dictate how much banks can lend to customers, and how much cash they must keep on hand), and deposit guarantees, among other tools. They also provide loans and services for a nation's banks and its government and manage foreign exchange reserves.

Finally, a central bank also acts as an emergency lender to distressed commercial banks and other institutions, and sometimes even a government. By purchasing government debt obligations, for example, the central bank provides a politically attractive alternative to taxation when a government needs to increase revenue.

2.1.1. Evolution of Central Banking

The first prototypes for modern central banks were the Bank of England and the Swedish Riks bank, which date back to the 17th century. The Bank of England was the first to acknowledge the role of lender of last resort. Other early central banks, notably Napoleon’s Bank of France and Germany's Reichs bank, were established to finance expensive government military operations.

It was principally because European central banks made it easier for federal governments to grow, wage war, and enrich special interests that many of United States' founding fathers—most passionately Thomas Jefferson—opposed establishing such an entity in their new country. Despite these objections, the young country did have both official national banks and numerous state-chartered banks for the first decades of its existence, until a “free-banking period” was established between 1837 and 1863.

2.1.2. Definition of a Central Bank

Definition: A central bank is a monetary institution, which fully controls the production, circulation, and the supply of money in the market, seeking to regulate the member banks and stabilize a nation’s economy and national currency.

What Does Central Bank Mean?

What is the definition of central bank? Central banks are responsible for the monetary policy implemented in a country, which includes decisions about interest rates, liquidity control, reserve requirements, and open market operations. When the monetary policy is effective, the centralized bank manages to keep the unemployment rate at low levels, and it stabilizes inflation and interest rates to stimulate economic growth. Although most centralized banks are governed by a board of member banks, they act independently. Also, the decisions of a centralized bank have a strong impact on every aspect of the economy, seeking to meet the nation’s long-term goals.

Let’s look at an example.

Fed in the United States and the European Centralized Bank in the European Union are responsible for controlling the liquidity of the market by implementing monetary policy measures. To achieve this goal, they use three main monetary policy tools, which are the interest rates, the reserve requirements, and the open market operations.

Central banks set short-term target interest rates pertaining to bonds, mortgages, and lending. If the centralized bank raises the interest rates, fewer banks will want to borrow from the central bank, thereby slowing down consumer lending and business lending. On the other hand, higher interest rates prevent inflation from rising further because the supply of money to the market slows down. Therefore, central banks use interest rates to control lending and borrowing in an economy.

Reserve requirements are the funds that a centralized bank must hold in reserve against specific liability types, such as net transaction accounts and nonperson time deposits. The Fed’s reserve requirements are 3% of liabilities for net transaction accounts between $15.5 million and $115.1 million, and 10% of liabilities for net transaction accounts of more than $115.1 million. In fact, reserve requirements offer an indication of how much money member banks can lend.

Finally, open market operations are used for the purchase and sale of securities such as Treasury bonds from member banks. By purchasing securities, the central bank increases the supply of money in the market, whereas by selling securities, it lowers the circulation of money in an economy.

Summary Definition

Define Central Banks: Central bank means a financial system allows one institution to control its money supply and interest rates.

2.1.3. Central Banking Functions

Central banks also have other important functions, of a less-general nature. These typically include acting as fiscal agent of the government, supervising the operations of the commercial banking system, clearing checks, administering exchange-control systems, serving as correspondents for foreign central banks and official international financial institutions, and, in the case of central banks of the major industrial nations, participating in cooperative international currency arrangements designed to help stabilize or regulate the foreign-exchange rates of the participating countries.

Central banks are operated for the public welfare and not for maximum profit. The modern central bank has had a long evolution, dating back to the establishment of the Bank of Sweden in 1668. In the process, central banks have become varied in authority, autonomy, functions, and instruments of action. Virtually everywhere, however, there has been a vast and explicit broadening of central-bank responsibility for promoting domestic economic stability and growth and for defending the international value of the currency. There also has been increased emphasis on the interdependence of monetary and other national economic policies, especially fiscal and debt-management policies. Equally, a widespread recognition of the need for international monetary cooperation has evolved, and central banks have played a major role in developing the institutional arrangements that have given form to such cooperation.

There are six ways by which central banks typically alter the volume of their assets:

1. "Open-market operations" consist mainly of purchases and sales of government securities or other eligible paper, but operations in bankers' acceptances and in certain other types of paper often are permissible. Open-market operations are an effective instrument of monetary regulation only in countries with well-developed securities markets. Open-market sales of securities by the central bank drain cash reserves from the commercial banks. This loss of reserves tends to force some banks to borrow from the central bank, at least temporarily. Banks faced with the cost of such borrowing, at what may well be a high discount rate, and also faced with the possibility of being admonished by the central bank about their lending policies typically become more restrictive and selective in extending credit. Open-market sales, by reducing the capacity of the banking system to extend credit and by tending to drive down the prices of the securities sold, also tend to raise the interest rates charged and paid by banks. The rise in government security yields and in the interest rates charged and paid by banks forces other financial institutions to offer a higher rate of return on their obligations, in order to be competitive, and, given the reduced availability of bank credit, enables them, like banks, to command a higher rate of return on their loans. Thus, the impact of open-market sales is not limited to the banking system; it is diffused throughout the economy. Conversely, purchases of securities by the central bank tend to lead to credit expansion by the financial system and to lower interest rates, unless the demand for credit is rising at a faster rate than the supply, which normally is the case once an inflationary process gets under way; interest rates then will rise rather than fall.

Changes in domestic money-market rates resulting from central-bank actions also tend to change the prevailing relations between domestic and foreign money-market rates, and this, in turn, may set in motion short-term capital flows into or out of the country.

Loans to banks, generally called “discounts” or “rediscounts,” are short-term advances against commercial paper or government securities to enable banks to meet seasonal or other special temporary needs either for loanable funds or for cash reserves to replace reserves lost as a result of shrinkage in deposits. The Bank of England ordinarily deals with discount houses rather than directly with banks, but the effect on bank reserves is similar. The provision of such advances is one of the oldest and most traditional functions of central banks. The rate of interest charged is known as the “discount rate,” or “rediscount rate.” By raising or lowering the rate, the central bank can regulate the cost of such borrowing. The level of and changes in the rate also indicate the view of the central bank on the desirability of greater tightness or ease in credit conditions.

Some central banks, especially in countries that lack a broad capital market, extend medium- and long-term credit to banks and to government development corporations in order to facilitate the financing of domestic economic-development expenditures and to alleviate the deficiency of financial savings. Such longer-term lending is not regarded as an appropriate central-bank activity by many authorities, however, and is considered a dangerous source of inflationary pressures.

Direct government borrowing from central banks generally is frowned upon as encouraging fiscal irresponsibility and commonly is subject to statutory limitation; nevertheless, in many countries the central bank is the only large source of credit for the government and is used extensively. In other countries indirect support of government financing operations has monetary effects that differ little from those that would have followed from an equal amount of direct financing by the central bank.

Central banks buy and sell foreign exchange to stabilize the international value of their own currency. The central banks of major industrial nations engage in so-called “currency swaps,” in which they lend one another their own currencies in order to facilitate their activities in stabilizing their exchange rates. Prior to the 1930s, the authority of most central banks to expand the money supply was limited by statutory requirements that restricted the capacity of the central bank to issue currency and (less commonly) to incur deposit liabilities to the volume of the central bank’s international reserves. Such requirements have been lowered or eliminated by most countries, however, either because they blocked expansions of the money supply at times when expansion was considered essential to domestic economic-policy objectives or because they “locked up” gold or foreign exchange needed for payments abroad.

Many central banks have the authority to fix and to vary, within limits, the minimum cash reserves that banks must hold against their deposit liabilities. In some countries the reserve requirements against deposits provide for the inclusion of certain assets in addition to cash. Generally, the purpose of such inclusion is to encourage or require banks to invest in those assets to a greater extent than they otherwise would be inclined to do and thus to limit the extension of credit for other purposes. Similarly, especially lower discount rates sometimes are used to encourage specific types of credit, such as to agriculture, housing, and small businesses.

In periods of intense inflationary pressure and shortage of supplies, especially during wartime and immediately thereafter, many governments have felt a need to impose direct measures to curb the availability of credit for particular purposes—such as the purchase of consumer durables, houses, and nonessential imported goods—and often have had these controls administered by their central banks. Such controls typically establish maximum loan-value to purchase-price ratios and maximum maturities that must be prescribed by lenders. These controls often apply to nonbank lenders as well as to bank lenders, and this is necessary for effectiveness in countries in which nonbank lenders are important sources of the types of credit being curbed. The general experience of central banks with direct credit controls has not been favorable; opportunities for evasion are too easy, especially if overall credit conditions are not extremely tight, and inequities in the impact of the controls become socially and politically troublesome. An early example of selective credit-control authority vested in a central bank and one that, on balance, has worked tolerably well is the authority conferred on the U.S. Federal Reserve Board in 1934 to establish margin requirements on stock-market credit.

2.1.4. Credit Control Methods

What are the main Methods of Credit Control?

The most important function of the Central Bank is to control credit. The Central Bank uses various methods to control credit. This method can be classified into two broad categories. They are:

Methods of Credit Controls

Quantitative Methods

1. Bank rate policy
2. Open market operations

3. Variation of cash reserve ratio

4. ‘Repo’ or Repurchase Transactions

Qualitative Methods

1. Fixation of margin requirements
2. Rationing of credit
3. Regulation of consumer credit
4. Controls through directives
5. Moral suasion
6. Publicity
7. Direct action

Let us discuss these methods one by one.

Quantitative Methods of Credit Control

The quantitative methods of credit control are the general and traditional methods. They aim at the regulation of the quantity of credit and not its application in various uses. They are expected to control and adjust the total quantity of deposits created by the commercial banks.

They relate to the volume in general. These methods are indirect in nature. The objectives of quantitative methods of credit control are as follows:

(i) Controlling the volume of credit in the economy.

(ii) Maintaining equilibrium between saving and investment in the economy.

(iii) Maintaining the stability in exchange rates.

(iv) Correcting disequilibrium in the balance of payments of the country.

(v) Removing shortage of money in the money market.

The important methods under this category are, 1. Bank Rate Policy

It is also known as discount rate policy. Bank rate is the rate at which the Central Bank is prepared to rediscount the approved bills or to lend on eligible paper.

This weapon can be used independently or along with other weapon. By changing this rate the Central Bank control the volume of credit. The bank rate is raised in times of inflation and is lowered in times of deflation.

A rise in the bank rate is usually preceded by the following events:

(i) Over supply of money and rising price level.

(ii) Great demand for money caused by active trade.

(iii) Adverse rate of exchange, and

(iv) Unfavorable balance of trade.

In times of adverse balance of payments and rising price level, the Central Bank increases the bank rate and thereby forces the market rates to go up. Because of this, credit becomes dear and borrowing from banks becomes costly. The speculators are discouraged to buy and stock goods.

They start selling their stock of goods in the market, and the prices take a downward trend. Exports begin to rise and the imports decline. Foreign investors are encouraged to keep their cash balances within the county so as to earn the increased rate of interest. The adverse balance of payments gradually disappears.

A rise in bank rate has the following consequences:

There is a corresponding rise in the market rate that is, the rate charged by financial institution.

The prices of fixed interest bearing securities tend to register a decline because the interest rate ruling in the market would be higher than the rate originally fixed on such securities.

A shift in investments from fixed interest bearing securities to equities results in a rise in the prices of the latter, especially, shares of growing companies.

There is shrinkage in investment on capital assets due to the shortage of finances.

Fall in the prices of consumer commodities due to less spending and the unloading of stocks.

Transference of foreign money into the country due to the high rates of interest ruling and the consequent improvement in the foreign exchange position.

Increase in exports.

But in times of falling prices, the Central Bank lowers the bank rate and brings about a fall in the market rates of interest. This will lead to increased volume of trade, investment, production and employment and ultimately leads to the rise in the price level.

Conditions for the Operation of Bank Rate Policy

To use the weapon of bank rate policy some basic requirements are to be fulfilled. The impact of a change in the Bank rate depends upon the following:

(i) Existence of close nexus between Bank Rate and market rates, i.e., the extent of the dependence of commercial banks on the Central Bank for funds.

(ii) The availability of funds to banks from other sources.

(iii) The extent to which other interest rates are directly influenced by changes in the bank rate. If the other rates of interest in the market do not respond to bank rate changes desired results cannot be realized.

(iv) The degree of importance attached to a change in the bank rate as an indicator of the monetary policy. There must be an organized short-term funds market in the country

(v) There must be a great measure of elasticity in the economic structure of the country. When prices fall, the various elements in the cost of production like wages citations of Bank Rate Policy. The report of Macmillan Committee stated that the bank rate policy is an absolute essay for the sound management of a monetary system. It is an important weapon of edit control. “But, it suffers from the following limitations:

.12.1.1.1. The rate of interest in money market may not change according to the changes in the bank rate.

.12.1.1.2. In rigid economic system, i.e., planned and regulated economies, the prices and costs may not change as a result of changes in the rate of interest.

.12.1.1.3. The bank rate cannot be the sole regulator of the economic system, and the volume of savings and investments cannot be controlled through the rate of interest alone. The effectiveness of changes in interest rate depends upon the elasticity of demand for capital goods.

.12.1.1.4. The effect of rise in the bank rate in controlling credit for industrial and commercial purpose is limited. If the businessmen take the view that prices will continue to rise, a slight rise in the rate of interest will not discourage them to expand their activity with borrowed money. So long as prices have a tendency to rise and so long as there is business optimism, businessmen would be willing to pay higher interest rates.

.12.1.1.5. In ties of depression, a fall in the rate of interest can hardly stimulate economic activity. Because the businessmen may not be prepared to increase their activity if they fear about the future. Prof. Sayers considers the bank rate as a halting, clumsy and indeed a brutal instrument.

.12.1.1.6. The change in the methods of financing by the business firms reduces the importance of bank rate policy In recent years the commercial banks have ample liquid resources of their own. The business firms depend more on sloughing back of profits than borrowing from commercial banks.

.12.1.1.7. The conflicting effects of bank rate also reduce the importance of this weapon. When the bank rate is increased the foreign capital may flow into the country, thus, making credit control difficult.

.12.1.1.8. Indiscriminate nature of bank rate policy: The bank rate policy does not discriminate the activities into productive and unproductive activities. It affects both the activities on the same footing. This will adversely affect the genuine productive activities with increased rate of interest.

Because of these limitations, the bank rate policy has lost its importance. But during e inflationary situations it can be used with some modifications. But it may not regain its order importance.

Open Market Operations

Open market operation refers to buying and selling of eligible securities by the Central Bank in the money market and capital market. The buying and selling of securities by the Central Bank results in an increase or decrease in the cash resources of the commercial banks. This in turn affects the credit creation of the commercial banks.

Open market opera- ions tend immediately to increase or decrease the quantity of money in circulation and the ash resource of Commercial Banks.

Objectives of Open Market Operation

The weapon of open market operation helps in achieving the following objectives:

(a) To make the bank rate policy effective and successful.

(b) To avoid disturbances in the money market as a result of movement of Government funds or seasonal movements of funds generally.

(c) To eliminate the effects of inflow or outflow of gold by import and export under Gold Standard.

(d) To support Government credit in connection with the issue of new loans or the conversion of the existing loans.

(e) To counteract extreme trends in business situation by buying securities during periods of low economic activity and selling them in periods of high economic activity.

(f) To create and maintain conditions of cheap money as an aid to business recovery.

(g) To avoid undue fluctuations in the prices of Government securities and to correct undesirable or unjustifiable spreads between the yields of various types of securities.

(h) To absorb an excess of liquid funds.

(i) To insulate the credit structure from sudden and temporary changes in the balances of payments position.

The most important reason is the decline of discount rate as an instrument of credit control and the consequent need for another and more direct method.

Open market operations became necessary in order to implement the policy of cheap money. These operations have been considerably facilitated as a result of increased volume and variety of Government and other gilt-edged securities traded in markets of most countries.

Method of Operation

If the Central Bank wants to reduce the volume of credit created by the banks, it sells eligible securities in the market. When the banks and the public purchase these securities, they have to make payments to the Central Banks.

This results in the movement of cash from Commercial Banks to Central Bank. As a result of this the primary reserves of the banks fall. Hence, the capacity of the banks to expand credit will be contracted. In times of inflation the Central Bank sells eligible securities in the open market.

When the Central Bank wants to expand the volume of credit, it starts buying the approved securities from the open market. Now, the Central Bank has to make payments to the commercial banks and the public for the purchases made from them.This result in the movement of cash from the Central Bank to commercial banks. As a result, the cash reserves in the hands of commercial banks will increase. They find themselves in a position to expand credit. This is followed during deflationary situations.

Prerequisites for the Success of Open Market Operations

(a) The market for the securities should be well organized, deep, active and broad based.

(b) The rate of interest offered on government securities should be competitive.

(c) The existence of sufficient number of securities.

(d) The willingness of commercial banks to lend.

(e) The maintenance of rigid cash reserve ratio by the commercial banks.

(f) Willingness of the general public to borrow money from the commercial banks.

(g) Commercial banks should not have direct access to accommodation "from the Central Bank.

Limitations of Open Market Operations

The following are the main limitations of the open market operations.

i. **Quantity of money circulation may not change:**

It depends upon the close connection that prevails between the operations and the quantity of money in circulation. Quantity of money should at least approximately change according to operations. But in actual practice it may not change in the desired direction due to two factors, such as hoarding and dishoarding of cash and inflow and outflow of capital, etc.

ii. **Influence of economic and political reasons:**

It is assumed that the commercial banks increase or decrease their loans and advances in accordance with the changes in their cash reserves. But they may not do so due to monetary, economic and political reasons. Even though there is an increase in their cash reserves, they may not expand the credit for want of credit-worthy borrowers.

iii. **Pessimistic approach of Businessmen affects the operations:**

The demand for bank credit cannot be wholly controlled by commercial banks or by the Central Bank, but it depends upon the actions if the businessmen. The Central Bank may buy securities and increase the cash base of the commercial banks. The commercial banks may be willing to expand credit. But the businessmen may not borrow if they are pessimistic about the future.

iv. **Not effective in developing countries:**

The effectiveness of open market operations depends upon the existence of a broad and active securities market, in short-term as well as long-term securities. But such markets are to be found only in advanced countries. However, the increased ' ovum of treasury bills in many countries are proving helpful for effective open market options.

v. **Dependence *of resources of the Central Bank:***

The Central Bank must be capable of launching operations on the necessary scale, which depends upon its resources. The resources of the Central Bank in turn depend upon its constitution and the policy of its Government.

(vi). Lacks immediate effect: The additional cash put into the money market by the Central Bank by purchasing of securities will not come to the commercial banks immediately as deposits. It

takes time to reach the commercial banks. Therefore the effect of this weapon may not be immediate due to this time lag.

2.1.5. Monetary Policy & its Objectives

In this topic we will discuss about:-

- Meaning of Monetary Policy
- Objectives of Monetary Policy
- Ultimate versus Intermediate Target
- Limited Scope
- Role in Developing Countries
- Role in Promoting Faster Economic Growth
- Targets.

Meaning of Monetary Policy:

Monetary policy is concerned with the changes in the supply of money and credit. It refers to the policy measures undertaken by the government or the central bank to influence the availability, cost and use of money and credit with the help of monetary techniques to achieve specific objectives. Monetary policy aims at influencing the economic activity in the economy mainly through two major variables, i.e., (a) money or credit supply, and (b) the rate of interest.

The techniques of monetary policy are the same as the techniques of credit control at the disposal of the central bank. Various techniques of monetary policy, thus, include bank rate, open market operations, variable cash reserve requirements, selective credit controls. R.P. Kent defines monetary policy as the management of the expansion and contraction of the volume of money in circulation for the explicit purpose of attaining a specific objective such as full employment.

According to A. J. Shapiro, "Monetary Policy is the exercise of the central bank's control over the money supply as an instrument for achieving the objectives of economic policy." In the words of D.C. Rowan, "The monetary policy is defined as discretionary action undertaken by the authorities designed to influence (a) the supply of money, (b) cost of money or rate of interest and (c) the availability of money."

Monetary policy is not an end in itself, but a means to an end. It involves the management of money and credit for the furtherance of the general economic policy of the government to achieve the predetermined objectives. There have been varying objectives of monetary policy in different countries in different times and in different economic conditions.

Different objectives clash with each other and there is a problem of selecting a right objective for the monetary policy of a country. The proper objective of the monetary policy is to be selected by the monetary authority keeping in view the specific conditions and requirements of the economy.

Objectives of Monetary Policy:

The goals of monetary policy refer to its objectives such as reasonable price stability, high employment and faster rate of economic growth. The targets of monetary policy refer to such variables as the supply of bank credit, interest rate and the supply of money.

These are to be changed by using the instruments of monetary policy for attaining the objectives (goals). The instruments of monetary policy are variation in the bank rate, the repo rate and other interest rates, open market operations (OMOs), selective credit controls and variations in reserve ratio (VRR). [The targets are to be changed by using the instruments to achieve the objectives.]

Four most important objectives of monetary policy are the following:

1. **Stabilizing the Business Cycle:**

Monetary policy has an important effect on both actual GDP and potential GDP. Industrially advanced countries rely on monetary policy to stabilize the economy by controlling business. But it becomes impotent in deep recessions.

Keynes pointed out that monetary policy loses its effectiveness during economic downturn for two reasons:

i. The existence of liquidity trap situation (i.e., infinite elasticity of demand for money) and
ii. Low interest elasticity of (autonomous) investment.

2. **Reasonable Price Stability**:

Price stability is perhaps the most important goal which can be pursued most effectively by using monetary policy. In a developing country like India the acceleration of investment activity in the face of a fall in agricultural output creates excessive pressure on prices. The food inflation in India is a proof of this. In such a situation, monetary policy has much to contribute to short-run price stability.

Due to various changes in the structure of the economy in a developing country like India some degree of inflation is inevitable. And mild inflation or a functional rise in prices is desirable to give necessary incentive to producers and investors. As P. A. Samuelson put it, mild inflation at the rate of 3% to 4% per annum lubricates the wheels of trade and industry and promotes faster economic growth.

Price stability is also important for improving a country's balance of payments. In the opinion of C. Rangarajan, "The increasing openness of the economy, the need to service external debt and the necessity to improve the share of our exports in a highly competitive external environment require that the domestic price level is not allowed to rise unduly**".** This is more so in view of the fact that India's major trading partners have achieved notable success in recent years in achieving price stability.

3. **Faster Economic Growth:**

Monetary policy can promote faster economic growth by making credit cheaper and more readily available. Industry and agriculture require two types of credit—short-term credit to meet working capital needs and long-term credit to meet fixed capital needs.

The need for these two types of credit can be met through commercial banks and development banks. Easy availability of credit at low rates of interest stimulates investment or expansion of society's production capacity. This in its turn, enables the economy to grow faster than before.

4. **Exchange Rate Stability:**

In an 'open economy'—that is, one whose borders are open to goods, services, and financial flows— the exchange-rate system is also a central part of monetary policy. In order to prevent large depreciation or appreciation of the rupee in terms of the US dollar and other foreign currencies under the present system of floating exchange rate the central bank has to adopt suitable monetary measures. India by the Reserve

5. **Conflicts among Objectives:**

In the long run there is no conflict between the first two objectives, viz., price stability and economic growth. In fact, price stability is a means to achieve faster economic growth. In the context of the Indian economy C. Rangarajan writes, **"It is price stability which provides the appropriate environment under which growth can occur and social justice can be ensured."**

However, in the short run there is a trade-off between price stability and economic growth. Faster economic growth is achieved by increasing-the availability of credit at a lower rate of interest. This amounts to an increase in the money supply.

But an increase in the money supply and the consequent rise in consumer demand tends to generate a high rate of inflation. This raises the question of what is the minimum acceptable rate of inflation which does not act as a growth-retarding factor. The question still remains unanswered.

There is also a conflict between exchange rate stability and economic growth. If the rupee depreciates in terms of the dollar, then RBI has to tighten its monetary screws, i.e., it has to raise the interest rate and reduce excess liquidity of banks (from which loans are made).

On the other hand in order to promote faster economic growth the RBI has to lower interest rate and make more credit available for encouraging private investment. Thus the RBI often faces a dilemma situation.

6. **Ultimate Versus Intermediate Targets:**

The ultimate target over which the central bank of a country wants to exercise control are three major macroeconomic variables such as the rate (level) of employment, the general price level (or the rate of inflation) and the rate of growth of the economy which is measured by the annual rate of increase of real GDP.

Now the question is how effectively does the RBI act on such targets? The truth is that RBI is not in a position to act on them directly. The main reason for this is its imperfect monitoring of the operation of the economy. This is attributable to lack of adequate, necessary and timely information about the key variables.

So what does the RBI do then? It has no other option but to control intermediate targets exert indirect influence on the ultimate targets and, of course, in a predictable manner. Important intermediate targets are the three money supply concepts (aggregates), viz., M1, M2 or M3 and, of course, the interest rate.

While the RBI seeks to control the rate of inflation by controlling the money supply, it exerts influence on economic growth by altering the interest rate structures which alter the incentives to invest in physical capital as opposed to that in financial (liquid) assets.

7. **Mode of Operation:**

The RBI's mode of operation as far as intermediate targeting on monetary aggregate is concerned is simple. At the start of each quarter, the Bank fixes the rate of growth of the money supply which, it thinks, is quite consistent with its ultimate target, viz., reasonable price level stability and faster economic growth.

The RBI takes decision on the basis of data on past performance as also forecast about the next quarter or over a full financial year. The RBI makes an appropriate choice of its policy action with a view to meeting this fixed target. At the start of the next quarter, the RBI makes a review of its money supply target and adjusts it appropriately on the basis of actual experience of the past.In 1998, the RBI made a sudden switch from a money supply targeting to a list of certain broad policy indicators. In spite of this broad monetary aggregate (mainly M,) is now perhaps*the most important of its policy stance.

There are two reasons for this:

(a) **Correct Prediction of Inflation:**

In India the rate of inflation is measured by the wholesale price index (WPI). And in the intermediate run (covering a period of 3 to 5 years), M3 is fairly accurate predictor of inflation.

(b) **Transparency:**

Most people in India have a fairly good idea of money supply targeting. With money supply targeting, the policy stance of the RBI is quite transparent and performs a signaling function. It gives a clear signal to the public and policymakers. The control of inflation depends much on the RBI's credibility reputation is a big factor here.

If the RBI does exactly what it announces people will believe in the RBI's commitment to achieve price stability by keeping the growth of the money supply within a target range? This is perhaps the best way to achieve anti-inflationary credibility by keeping people's inflationary expectations at a low level. Interest rate targeting is not that effective as an anti-inflationary measure.

8. **Limited Scope of Monetary Policy in Developing Countries:**

Monetary policy influences economic activity in two ways:

1. **Directly through Money Supply:**

Money supply is directly related to the level of economic activity. An increase in money supply increases economic activity by enabling people to purchase more goods and services, and vice versa.

2. Indirectly through Rate of Interest:

A change in money supply influences economic activity through its impact on rate of interest and investment. Increase in money supply reduces the rate of interest, which in turn, increases investment, and hence promotes economic activity, and vice versa.

The monetary policy in an economy works through two main economic variables, i.e., money supply and the rate of interest. The efficient working of the monetary policy, however, requires the fulfillment of three basic conditions- (a) The country must have highly organized, economically independent and efficiently functioning money and capital markets which enable the monetary authority to make changes in money supply and the rate of interest as and when needed, (b) Interest rates can be regulated both by administrative controls and by market forces so that consistency and uniformity exists in interest rates of different sectors of the economy, (c) There exists a direct link between interest rates, investment and output so that a reduction in the interest rate (for example) leads to an increase in investment and an expansion in output without any restriction.

The developed countries largely satisfy all the necessary prerequisites for the efficient functioning of the monetary policy, whereas the developing or underdeveloped economies normally lack these requirements.

The monetary policy has the limited scope in the underdeveloped countries because of the following reasons:

(a) There exists a large non-monetized sector in most of the underdeveloped countries which act as a great hurdle in the successful working of the monetary policy.

(b) Small-sized and unorganized money market and limited array of financial assets in underdeveloped countries also hinder the effectiveness of monetary policy.

(c) In most of the underdeveloped countries, total money supply mainly consists of currency in circulation and bank money forms a very small portion of it. This limits the operation of central bank's monetary policy which basically works through its impact on bank money.

(d) The growth of nonbank financial institutions also restricts the effective implementation of monetary policy because these institutions fall outside the direct control of the central bank.

(e) In the underdeveloped countries (e.g., in Libya), many commercial banks possess high level of liquidity (i.e, funds in cash form). In these cases, the changes in monetary policy cannot significantly influence the credit policies of such banks.

(f) Foreign-based commercial banks can easily neutralize the restrictive effects of tight monetary policy because these banks can replenish their resources by selling foreign assets and can also receive help from international capital market.

(g) The scope of monetary policy is also limited by the structural and institutional realities of the underdeveloped countries, weak linkage between interest rate, investment and output, particularly due to structural supply rigidities.

When investment is increased as a result of a fall in the rate of interest, increased investment may not expand output due to the structural supply constraints, such as inadequate management, lack of essential intermediate products, bureaucratic rigidities, licensing restrictions, lack of interdependence within the industrial sector. Thus, higher investment, instead of increasing output, may generate inflationary pressures by raising prices.

3. Role of Monetary Policy in Developing Countries:

The monetary policy in a developing economy will have to be quite different from that of a developed economy mainly due to different economic conditions and requirements of the two types of economies. A developed country may adopt full employment or price stabilization or exchange stability as a goal of the monetary policy.

But in a developing or underdeveloped country, economic growth is the primary and basic necessity. Thus, in a developing economy the monetary policy should aim at promoting economic growth. The monetary authority of a developing economy can play a vital role by adopting such a monetary policy which creates conditions necessary for rapid economic growth.

9. Monetary policy can serve the following developmental requirements of developing economies:

1. Developmental Role:

In a developing economy, the monetary policy can play a significant role in accelerating economic development by influencing the supply and uses of credit, controlling inflation, and maintaining balance of payment.

Once development gains momentum, effective monetary policy can help in meeting the requirements of expanding trade and population by providing elastic supply of credit.

2. Creation and Expansion of Financial Institutions:

The primary aim of the monetary policy in a developing economy must be to improve its currency and credit system. More banks and financial institutions should be set up, particularly in those areas which lack these facilities.

The extension of commercial banks and setting up of other financial institutions like saving banks, cooperative saving societies, mutual societies, etc. will help in increasing credit facilities, mobilizing voluntary savings of the people, and channelizing them into productive uses.

It is also the responsibility of the monetary authority to ensure that the funds of the institutions are diverted into priority sectors or industries as per requirements of be development plan of the country.

3. Effective Central Banking:

To meet the developmental needs the central bank of an underdeveloped country must function effectively to control and regulate the volume of credit through various monetary instruments, like bank rate, open market operations, cash-reserve ratio etc. Greater and more effective credit controls will influence the allocation of resources by diverting savings from speculative and unproductive activities to productive uses.

4. Integration of Organized and Unorganized Money Market:

Most underdeveloped countries are characterized by dual monetary system in which a small but highly organized money market on the one hand and large but unorganized money market on the other hand operates simultaneously.

The unorganized money market remains outside the control of the central bank. By adopting effective measures, the monetary authority should integrate the unorganized and organized sectors of the money market.

5. Developing Banking Habits:

The monetary authority of a less developed country should take appropriate measures to increase the proportion of bank money in the total money supply of the country. This requires increase in the bank deposits by developing the banking habits of the people and popularizing the use of credit instruments (e.g, cheques, drafts, etc.).

6. Monetization of Economy:

An underdeveloped country is also marked by the existence of large non-monetized sector. In this sector, all transactions are made through barter system and changes in money supply and the rate of interest do not influence the economic activity at all. The monetary authority should take measures to monetize this non-monetized sector and bring it under its control.

7. Integrated Interest Rate Structure:

In an underdeveloped economy, there is absence of an integrated interest rate structure. There is wide disparity of interest rates prevailing in the different sectors of the economy and these rates do not respond to the changes in the bank rate, thus making the monetary policy ineffective.

The monetary authority should take effective steps to integrate the interest rate structure of the economy. Moreover, a suitable interest rate structure should be developed which not only encourages savings and investment in the country but also discourages speculative and unproductive loans.

8. Debt Management:

Debt management is another function of monetary policy in a developing country. Debt management aims at- (a) deciding proper timing and issuing of government bonds, (b) stabilizing their prices, and (c) minimizing the cost of servicing public debt.

The monetary authority should conduct the debt management in such a manner that conditions are created "in which public borrowing can increase from year to year and on a big scale without giving any jolt to the system. And this must be on cheap rates to keep the burden of the debt low."

However, the success of debt management requires the existence of a well- developed money and capital market along with a variety of short- term and long-term securities.

9. Maintaining Equilibrium in Balance of Payments:

The monetary policy in a developing economy should also solve the problem of adverse balance of payments. Such a problem generally arises in the initial stages of economic development when the import of machinery, raw material, etc., increase considerably, but the export may not increase to the same extent. The monetary authority should adopt direct foreign exchange controls and other measures to correct the adverse balance of payments.

10. Controlling Inflationary Pressures:

Developing economies are highly sensitive to inflationary pressures. Large expenditures on developmental schemes increase aggregate demand. But, output of consumer's goods does not increase in the same proportion. This leads to inflationary rise in prices.

Thus, the monetary policy in a developing economy should serve to control inflationary tendencies by increasing savings by the people, checking expansion of credit by the banking system, and discouraging deficit financing by the government.

11. Long-Term Loans for Industrial Development:

Monetary policy can promote industrial development in the underdeveloped countries by promoting facilities of medium-term and long-term loans to tire manufacturing units. The monetary authority should induce these banks to grant long-term loans to the industrial units by providing rediscounting facilities. Other development financial institutions also provide long-term productive loans.

12. Reforming Rural Credit System:

Rural credit system is defective and rural credit facilities are deficient in the under-developed countries. Small cultivators are poor, have no finance of their own, and are largely dependent on loans from village money lenders and traders who generally exploit the helplessness, ignorance and necessity of these poor borrowers. The monetary authority can play an important role in providing both short-term and long term credit to the small arrangements, such as the establishment of cooperative credit societies, agricultural banks etc.

Conclusion:

It is true that monetary policy in a developing economy can play a positive role in facilitating the process of economic development by influencing the supply and use of credit through well-developed credit institutions, checking inflation, maintaining balance of payments equilibrium, providing loan facilities to industrial and agricultural sectors, and so on.

But it must be clearly borne in mind that the role of monetary policy in economic development is secondary and indirect, and not primary and direct. The fundamental problem of underdeveloped countries are that of inadequate saving which cannot be solved merely by creating financial institutions. The growth of saving basically depends upon the increase in productive capacity and income of the country.

Financial institutions only provide facilities to encourage savings and smoothen the process of economic development; they are not the primary movers of economic development. A.S. Meier and Baldwin put it, “The currency and credit system must be responsive to the stimuli of development, but monetary and financial institutions in themselves cannot be expected to be the primary and active movers of development in a direct sense.”

The Role of Monetary Policy in Promoting Faster Economic Growth:

Economic growth refers to a sustainable or a continuous increase in national and per capita incomes. This occurs when there is an increase in an economy’s capital stock through an increased investment. As a result there is expansion of the economy’s production capacity. This enables the economy to produce more goods and services every year. In truth, faster economic growth can be attained by an economy largely if not entirely, by increasing the rate of saving and investment.

How this can be achieved by using monetary policy may now be discussed:

1. **Increasing the Rate of Saving:**

If monetary policy is to promote economic growth, it has to raise the rate of saving. In a developing country like India, the central bank should raise the rate of interest to a reasonable level to induce people to save more. So, larger and larger volume of resources will be available for investment (particularly in fixed assets).

In times of inflation the nominal rate of interest has to be raised so that the real rate of interest remains constant. In fact in order to mobilize more and more saving through the banking system for investment purposes, it is absolutely essential to maintain reasonable price stability so that people have less incentive to buy gold, real estate or goods for hoarding and speculation. If due to excessive rise in price the real rate of interest becomes negative, people will have less incentive to save.

However, the rate of interest affects only people’s desire to save. But their capacity to save depends, apart from income, on the existence of banks and other financial institutions. So the governments of developing countries should build a strong financial infrastructure by setting up banks, post offices, insurance companies, stock exchanges, mutual funds, and pension funds mainly in rural areas where the majority of the people live.

2. **Monetary Policy and Investment:**

Even if the rate of interest is very low, private enterprises may not be willing to make new investment in time of depression due to lack of profitable business opportunities. This, of course, is Keynes's view. But in normal times an increase in the supply of money due to an increase in bank credit leads to an increased investment. In addition in a developing country public (government) investment plays an important role in economic development. So, monetary policy should also make adequate funds available for public investment.

(a) Monetary Policy and Public Investment:

The monetary policy of a developing country like India has to be such as to ensure that a large portion of deposits mobilized by banks is invested in government and other approved securities so as to enable the government to finance its planned investment. Infrastructure building is so important for economic development. So public investment has to be made to set up power plants, build roads, highways and ports. Such investment promotes industrial development directly and indirectly (by establishing backward and forward linkages). As a result there is a tremendous increase in demand for industrial products.

Each industry purchases inputs from other industries and sells its products to both households and other businesses. The operation of multiplier stimulates private investment further. Thus public investment on social overhead capital will crowd in, rather than crowd out, private investment. Moreover, construction of irrigation dams promotes agricultural growth by raising both production and productivity.

In India, a new tool of monetary control has been introduced for taking out large resources from the banking sector for financing public investment, viz., statutory liquidity ratio (SLR). Now in addition to keeping cash reserves commercial banks are to keep a minimum portion of their total demand and time deposits in some specified liquid assets, mainly in government and other approved securities'.

(b) Monetary Policy and Private Investment:

Since both large-scale and medium-size industries require funds for investment in fixed capital, working capital as also for holding inventories (of both finished goods and raw materials) monetary policy has also to ensure that the need for bank credit for investment and production in the private sector is fully satisfied.

3. **Adequate bank credit is necessary for two purposes:**

i. To utilize the existing production capacities in the private sector and
ii. To create additional capacity. Banks must also provide adequate credit to meet the minimum working capital needs of agriculture and industry.

(c) Allocation of Investment Funds:

The mobilization of savings is not enough. Savings are to be utilized for productive investment. So, monetary policy should be discriminatory in nature. It should restrict the flow of credit in unproductive sectors and wasteful activities which are inimical to economic growth. At the same time it should direct the flow of credit in productive channels.

So there is need for much stricter application of selecting credit control (SCC) mainly with a view to influencing the pattern of investment. SCC also helps the process of development indirectly by checking price rise and thus avoiding the distortion created by double digit inflation. However, it has to be supported by proper credit rationing.

In addition, measures such as lengthening the periods of repayment of loans, lowering of margin requirements, and provision of rediscounting facilities at rates below the market rates, interest and provision of special loans to entrepreneurs setting up labor-intensive industries in backward areas are to be adopted for promoting faster industrial growth.

Monetary policy should provide the necessary incentives to channelize saving in the desired direction. This is supposed to widen the horizons of development in accordance with the pre-determined goals of planning.

4. **Targets for Monetary Policy:**

Conditions of a Good Target:

In order to become a good target for monetary policy a variable should satisfy the following conditions:

(a) Measurability:

The target variable should be easily measurable with little or no time lag. To meet this condition, accurate and reliable data must be available. The data should also conform to the theoretical definitions of the target variables.

(b) Attainability:

The monetary authority should be able to attain its targeted goals; otherwise, setting the targets will be an exercise in futility. The targets which are unattainable are not practical. A target will be attainable when- (a) it is rapidly affected by policy instruments; and (b) there are no or very little non-policy influences on it.

(c) Relatedness to Goal Variables:

The target variable should be closely related to the higher level goal variables and this relation should be well understood and reliably estimable. For example, even if the monetary authority is able to attain the interest rates target, all is in vain if the interest rates do not affect the ultimate goals of employment. The price level the rate of economic growth, and the balance of payments.

(d) Superiority of Target Variables:

There are three main variables used as monetary targets. They are- money supply, bank credit and interest rates. Which of these variables is superior and chosen as target variable depends upon how far it satisfies the three criteria of measurability, attainability and relatedness to ultimate goals.

In spite of certain conceptual and practical difficulties in the measurement of target variables, all the three variables satisfy equally well the criterion of measurability and can be estimated with reasonable accuracy. As regard the condition of attainability, both money supply and bank credit meet equally well this condition, whereas interest rates do not fulfill it satisfactorily.

All the interest rates in the market do not change together and equi-proportionately. Interest rates are also not affected by the policy instruments as rapidly as other target variables are. Moreover, non-policy factors greatly influence the interest rates.

As regards the fulfillment of the criterion of relatedness to goal variables, the economists differ sharply. The Keynesians recommend interest rate as appropriate target variable, while the monetarists prescribe money supply. Practical central bankers, on the other side, consider bank credit as a better target variable.

5. **Economists are not in agreement as to which one is the best target variable:**

i. On the basis of the criteria of measurability and attainability, both money supply and bank credit are better target variables than interest rates.

ii. As between money supply and bank credit, money supply is definitely superior because there exists weak theoretical and empirical evidence in support of close causal link between credit and higher goals variables.

iii. Money supply is much more easily influenced by policy instruments than interest rates and the weight of policy factors is heavier than non- policy factors on money supply variable.

iv. Empirically also, the relation between money supply and the level of economic activity (and thus other goal variables) is stable and calculable. The same cannot be said about interest rates.

Recently, Benjamin Friedman, a Harvard economist, has suggested that the best intermediate target would be a combination of a credit variable target and a monetary growth target. Such a system, according to him, would draw on a more diverse and hence more reliable information base for the signals that govern the systematic response of monetary policy to emerging developments.

Under such a system, the central bank would select one monetary aggregate and total net credit, specify growth rate together for both and carry out open market operations aimed at achieving both targets. A deviation in either target from its respective target range would require a change in open market operations.

2.1.6. Regulation of the financial system

Financial regulation is a form of regulation or supervision, which subjects financial institutions to certain requirements, restrictions and guidelines, aiming to maintain the integrity of the financial system. This may be handled by either a government or non-government organization. Financial regulation has also influenced the structure of banking sectors by increasing the variety of financial products available. Financial regulation forms one of three legal categories which constitutes the content of financial law, the other two being market practices, case law.In the early modern period, the Dutch were the pioneers in financial regulation. The first recorded ban (regulation) on short selling was enacted by the Dutch authorities as early as 1610.

Aims of regulation

- The objectives of financial regulators are usually:
- market confidence – to maintain confidence in the financial system
- financial stability – contributing to the protection and enhancement of stability of the financial system
- Consumer protection – securing the appropriate degree of protection for consumers.

2.1.7. Central banking system in Ethiopia

The National Bank of Ethiopia (NBE) is the central bank of Ethiopia. Its headquarters are in the capital city of Addis Ababa. Ato Mamo is the current governor of the bank.

The bank is active in promoting financial inclusion policy and is a member of the Alliance for Financial Inclusion (AFI)

February 15, 1906, marked the beginning of banking in Ethiopia when the first Bank of Abyssinia was inaugurated by Emperor Menelik II. It was a private bank whose shares were sold in Addis Ababa, New York, Paris, London, and Vienna. The bank opened numerous branches including ones in Harar (1906), Dire Dawa (1908), Gore (1912), and Dese (1920). One of the first projects the bank financed was the Franco-Ethiopian Railway which reached Addis Ababa in 1917. The bank then opened a transit office in Djibouti in 1920.

In 1931, Emperor Haile Selassie introduced reforms into the banking system. The Bank of Abyssinia was liquidated the newly established Bank of Ethiopia, a fully government-owned bank, taking over management, staff and premises of the ceased bank. The Bank of Ethiopia provided central and commercial banking services to the country. However, the Italian invasion in 1935 brought the demise of one of the earliest initiatives in African banking. During the Italian occupation, Italian banks were active in Ethiopia.

On April 15, 1943, the State Bank of Ethiopia became the central bank and was active until 1963. By the time it ceased operations in 1963, the State Bank of Ethiopia had established 19 domestic branches, a branch in Khartoum, and a transit office in Djibouti.

The National Bank of Ethiopia was established in 1963 by Proclamation 206 of 1963 and began operation in January 1964. The establishment of the new organization was aided by U.S Department of State emissary, Earle O. Latham, who was the first Vice President of the Federal Reserve Bank of Boston.

Prior to this proclamation, the bank carried out dual activities i.e. commercial banking and central banking. The proclamation raised the bank's capital to 10 million Ethiopian Dollars and granted broad administrative autonomy and juridical personality. Following the proclamation the National Bank of Ethiopia was entrusted with the following responsibilities:

- To regulate the supply, availability and cost of money and credit.
- To manage and administer the country's international reserves.
- To license and supervise banks and hold commercial banks reserves and lend money to them.
- To supervise loans of commercial banks and regulate interest rates.
- To issue paper money and coins.

- To act as an agent of the Government.
- To fix and control the foreign exchange rates.

However, monetary and banking proclamation No. 99 of 1976 came into force on September 1976 to shape the bank's role according to the socialist economic principle that the country adopted. Hence the bank was allowed to participate actively in national planning, specifically financial planning, in cooperation with the concerned state organs. The bank's supervisory area was also increased to include other financial institutions such as insurance institutions, credit cooperatives and investment-oriented banks. Moreover, the proclamation introduced the new 'Ethiopian birr' in place of the former Ethiopian Dollar that ceased to be legal tender.

2.2. Commercial Banking system

Banks play two key roles in the functioning of the economy, first by facilitating the payments system and second by serving as financial intermediaries.

Banks are a critical intermediary in what is called the **payments system**, which helps an economy exchange goods and services for money or other financial assets. Banks make it far easier for a complex economy to carry out the extraordinary range of transactions that occur in goods, labor, and financial capital markets. Imagine for a moment what the economy would be like if all payments had to be made in cash. When shopping for a large purchase or going on vacation you might need to carry hundreds of dollars in a pocket or purse. Even small businesses would need stockpiles of cash to pay workers and to purchase supplies. A bank allows people and businesses to store this money in either a checking account or savings account, for example, and then withdraw this money as needed through the use of a cash withdrawal, writing a check, using a debit card, or some other form of electronic payment.

Banks are a convenient place to store one's savings, rather than looking for a person or business that is willing to borrow from them and then repay them at a later date. **Transaction costs** are the costs associated with finding a lender or a borrower for this money. Thus, banks lower transactions costs and act as financial intermediaries—they bring savers and borrowers together. Along with making transactions much safer and easier, banks also play a key role in the creation of money.

An "intermediary" is one who stands between two other parties. Banks are a **financial intermediary** that is, an institution that operates between a saver who deposits money in a bank and a borrower who receives a loan from that bank. All the funds deposited are mingled in one big pool, which is then loaned out. Figure 1 illustrates the position of banks as financial intermediaries, with deposits flowing into a bank and loans flowing out. Of course, when banks make loans to firms, the banks will try to funnel financial capital to healthy businesses that have good prospects for repaying the loans, not to firms that are suffering losses and may be unable to repay.

Financial intermediaries include other institutions in the financial market such as insurance companies and pension funds, but they are not included in this discussion because they are not considered to be **depository institutions**, which are institutions that accept money deposits and then use these to make loans.

Banks offer a range of accounts to serve different needs. A **checking account** typically pays little or no interest, but it facilitates transactions by giving you easy access to your money, either by writing a check or by using a **debit card** (that is, a card which works like a credit card, except that purchases are immediately deducted from your checking account rather than billed separately through a credit card company). A **savings account** typically pays some interest rate, but getting the money typically requires you to make a trip to the bank or an automatic teller machine (or you can access the funds electronically). The lines between checking and savings accounts have blurred in the last couple of decades, as many banks offer checking accounts that will pay an interest rate similar to a savings account if you keep a certain minimum amount in the account, or conversely, offer savings accounts that allow you to write at least a few checks per month.

Another way to deposit savings at a bank is to use a **certificate of deposit (CD)**. With a CD, you agree to deposit a certain amount of money in the account for a fixed period of time, typically ranging from a few months to several years. In exchange, the bank agrees to pay a higher interest rate than for a regular savings account. While you can withdraw the money before the allotted time, as the advertisements for CDs always warn, there is “a substantial penalty for early withdrawal.”

The great advantages of bank accounts are that financial investors have very easy access to their money, and also money in bank accounts is extremely safe. In part, this safety arises because a bank account offers more security than keeping a few thousand dollars in the toe of a sock in your underwear drawer. In addition, the Federal Deposit Insurance Corporation (FDIC) protects the savings of the average person. Every bank is required by law to pay a fee to the FDIC, based on the size of its deposits. Then, if a bank should go bankrupt and not be able to repay depositors, the FDIC guarantees that all customers will receive their deposits back up to $250,000.The bottom line on bank accounts looks like this: low risk means low rate of return but high liquidity.

Banks have a couple of close cousins: savings institutions and credit unions. Banks, as explained, receive deposits from individuals and businesses and make loans with the money. Savings institutions are also sometimes called "savings and loans" (S&L) or "thrifts." They also take loans and make deposits. However, from the 1930s until the 1980s, federal law limited how much interest savings institutions were allowed to pay to depositors. They were also required to make most of their loans in the form of housing-related loans, either to homebuyers or to real-estate developers and builders.

A **credit union** is a nonprofit financial institution that its members own and run. Members of each credit union decide who is eligible to be a member. Usually, potential members would be everyone in a certain community, or groups of employees, or members of a certain organization. The credit union accepts deposits from members and focuses on making loans back to its members. While there are more credit unions than banks and more banks than savings and loans, the total assets of credit unions are growing. Both credit unions and savings institutions are considered depository institutions.

2.2.1. Definition of commercial banking

What Is Commercial Banking?

Commercial bankers provide financial products and services to corporations, institutions, and governments.

In a nutshell, commercial banking refers to banking products and services designed for corporations, institutions, and sometimes governments, as opposed to banking products offered to individual consumers. Commercial banking, also known as business banking or institutional banking, refers to banking products and services designed for corporations, institutions, and sometimes governments. In addition to deposit products like checking and savings accounts, commercial banks offer merchant services, commercial loans, global trade services, treasury services, and other corporate-oriented products.

2.2.2. Commercial banking services

The bank offers wide range of operations for its customers; offering a full suite of innovative customer products and services to meet their objective of achieve wealth and transaction needs. The firm has adopted a customer focused approach which has enabled a deeper understanding of customer's evolving business needs and in providing customized financial products/services.

Many of the products offered by commercial banks are similar to those offered to individuals by retail banks, such as checking and savings accounts. However, many of the products and services offered by commercial banks are specifically designed to meet the financial needs of corporations and institutions. For example; when a retail business works with a bank to assist with payment processing services, that's an example of a commercial banking service.

Products and services offered by commercial banks

Some of the products offered by commercial banks are quite similar to those most people use every day. This includes checking and savings accounts, and while these accounts are specifically designed for corporate needs, their basic structure is the same. In addition to these deposit products, commercial banks offer an array of other products and services. While not all commercial banks offer each one, these may include:

- Merchant services, such as credit card processing, mobile payment solutions, gift cards, and electronic check services
- Global trade services, such as foreign exchange, financing, letters of credit, and global payments
- Treasury management services, such as fund collecting and disbursement, and fraud prevention
- Lending services, such as working capital for businesses, commercial real estate lending, equipment financing, and other types
- Retirement products and services for businesses and their employees
- Employee stock ownership plans
- Insurance products designed for corporations and institutions
- Advisory services
- Specialized services for certain types of businesses, such as auto dealer services, aircraft lending, investment real estate lending, and others

Other types of banking

In addition to commercial banking, there are several other varieties of banking products and services:

Investment banking**:** Investment banks provide services to corporations, governments, and individuals. These services include raising financial capital by underwriting debt or equity issuances, and assisting in mergers and acquisitions.

Retail banking**:** This is what most people think of when they hear the word "bank." Retail banking refers to any banking services that are intended for everyday consumers. This includes checking and savings accounts, credit cards, mortgages, auto loans, CDs, and more.

Private banking**:** Similar to retail banking, private banking refers to banking and financial services provided to high-net-worth individuals. Private bankers provide financial and wealth management services on a much more personal level than traditional retail banks, which is why it can be considered a separate type of banking.

One of the major services of a bank is to supply cash on demand, whether it is a depositor withdrawing money or writing a check, or a bank customer drawing on a credit line. A bank also needs funds to pay bills, but while bills are predictable in both amount and timing, cash withdrawals by customers are not.

Hence, a bank must maintain a certain level of cash compared to its liabilities to maintain solvency. A bank must hold some cash as reserves, which is the amount of money held in a bank's account at the Federal Reserve (Fed). The Federal Reserve determines the legal reserves, which is the minimum amount of cash that banks must hold in their accounts to ensure the safety of banks and also allows the Fed to effect monetary policy by adjusting the reserve level. Often, banks will keep excess reserves for greater safety.

To do business at its branches and automated teller machines (ATMs), a bank also needs vault cash, which includes not only cash in its vaults, but also cash elsewhere on a bank's premises, such as in teller drawers, and the cash in its ATM machines.

Some banks, usually smaller banks, also have accounts at larger banks, called correspondent banks. Which are usually larger banks that often borrow from the smaller banks or perform services for them. This relationship makes lending expeditious because many of these smaller banks are rural and have excess reserves whereas the larger banks in the cities usually have a deficiency of reserves.

Another source of cash is cash in the process of collection. When a banks receives a check, it must present the check to the bank on which it is drawn for payment, and, previously, this has taken several days. Nowadays, checks are being processed electronically and many transfers of funds are being conducted electronically instead of using checks. So this category of cash is diminishing significantly, and will probably disappear when all financial transactions finally become electronic.

Cash equivalents are another short-term asset, so-called because they are nearly equivalent to cash: short-term investments that can either be used as cash or can be quickly converted to cash without loss of value, such as demand deposits, T-bills, and commercial paper. A primary characteristic of financial instruments that are classified as cash equivalents is that they have a short-term maturity of 3 months or less, so interest rate risk is minimal, and they are the most highly rated securities or issued by a government that can print its own money, such as the T-bills issued by the US government, so there is little credit risk.

Loans are the major asset for most banks. They earn more interest than banks have to pay on deposits, and, thus, are a major source of revenue for a bank. Often banks will sell the loans, such as mortgages, credit card and auto loan receivables, to be securitized into asset-backed securities which can be sold to investors. This allows banks to make more loans while also earning origination fees and/or servicing fees on the securitized loans.

Loans include the following major types:

- business loans, usually called commercial and industrial (C&I) loans
- real estate loans
- residential mortgages
- home equity loans
- commercial mortgages
- consumer loans
- credit cards
- auto loans
- interbank loans

2.2.3. Domestic and international banking operation

The difference between the two is clear — banks with presence in multiple countries are called as 'international banks' while banks which operate within the boundaries of a country are called domestic banks;

Another way of looking at these banks is that, banks which are having their registered office, in a country, say India, and operating within the country, are called domestic banks in India; similarly banks which are having their registered office abroad and operating in in the home land are called foreign banks;

the domestic banks are required to adhere to the local laws of the country it is registered in, whereas an international company has to comply with the local laws of the county it is head quartered and also that of the laws of the country that it is operating in;

the domestic banks are not impacted by fluctuations in foreign currency rate whereas an international bank is impacted by such fluctuations;

Today, banks are no longer limited to retail deposit-taking and lending operations; they engage in wholesale banking activities, off-balance sheet business, and activities beyond domestic markets. The principles of all these types of bank services are lucidly discussed. Separate chapters provide general background on payments systems, Eurocurrency markets, bank safety and depositor protection. The authors' conception is unique in providing a comparative study in a geographical sense (they deal with banking in the U.S., Britain, and Australia) and in an institutional sense, tracing parallels between operations of banks and other financial institutions, particularly insurance companies. With the growing impact of financial innovations and the internationalization of financial markets, Domestic and International Banking is the innovative text needed for courses on monetary and banking policy and on capital markets and financial institutions.

International Banking can be defined as banking transactions crossing national boundaries. The activities involves like international lending; claims of domestic bank offices on foreign residents, claims of foreign bank offices on local residents, claims of domestic bank offices on domestic residents in foreign currency are the major activities involved in International Banking.

International banking is a denotation of cross-border and cross currency facets of banking business.

They classify international banking into two main activities; traditional foreign banking and euro currency banking; where traditional banking involves transactions with non-residents in domestic currency to allow trade finance and other international transactions, whilst Euro currency banking involves banks participating in foreign exchange transactions with both residents and non-residents.

The general idea of explaining about International Banking is to obtain a basic idea of international banking and its activities.

2.3. Summary

Banking systems perform several different functions, depending on the network of institutions. For example, payment and loan functions at commercial banks allow us to deposit funds and use our checking accounts and debit cards to pay our bills or make purchases. They can also help us finance our cars and homes. Many banks are profit-seeking entities with stockholders. They obtain profits by charging more interest for loans and paying less interest on deposits.

A central bank is a financial institution given privileged control over the production and distribution of money and credit for a nation or a group of nations. In modern economies, the central bank is usually responsible for the formulation of monetary policy and the regulation of member banks.

By easing or tightening the money supply and availability of credit, central banks seek to keep a nation's economy on an even keel. A central bank sets requirements for the banking industry, such as the amount of cash reserves banks must maintain vis-à-vis their deposits. A central bank can be a lender of last resort to troubled financial institutions and even governments.

Commercial bankers provide financial products and services to corporations, institutions, and governments.

Commercial banking, also known as business banking or institutional banking, refers to banking products and services designed for corporations, institutions, and sometimes governments. In addition to commercial banking, there are several other varieties of banking products and services:

- **Investment banking**
- **Retail banking**
- **Private banking:**

International Banking can be defined as banking transactions crossing national boundaries. The activities involves like international lending; claims of domestic bank offices on foreign residents, claims of foreign bank offices on local residents, claims of domestic bank offices on domestic residents in foreign currency are the major activities involved in International Banking.

Central banks also have other important functions, of a less-general nature. These typically include acting as fiscal agent of the government, supervising the operations of the commercial banking system, clearing checks, administering exchange-control systems, serving as correspondents for foreign central banks and official international financial institutions, and, in the case of central banks of the major industrial nations, participating in cooperative international currency arrangements designed to help stabilize or regulate the foreign-exchange rates of the participating countries.

Central banks are operated for the public welfare and not for maximum profit.

There are six ways by which central banks typically alter the volume of their assets:

1. "Open-market operations"
2. Loans to banks,
3. Direct government borrowing from central banks
4. Central banks buy and sell foreign exchange
5. Many central banks have the authority to fix and to vary, within limits
6. In periods of intense inflationary pressure and shortage of supplies

What are the main Methods of Credit Control?

The most important function of the Central Bank is to control credit.

Methods of Credit Controls

Quantitative Methods

- Bank rate policy
- Open market operations
- Variation of cash reserve ratio
- 'Repo' or Repurchase Transactions

❖ **Qualitative Methods**

  - Fixation of margin requirements
  - Rationing of credit

- Regulation of consumer credit
- Controls through directives
- Moral suasion
- Publicity
- Direct action

Let us discuss these methods one by one.

The objectives of quantitative methods of credit control are as follows:

a. Controlling the volume of credit in the economy.
b. Maintaining equilibrium between saving and investment in the economy.
c. Maintaining the stability in exchange rates.
d. Correcting disequilibrium in the balance of payments of the country.
e. Removing shortage of money in the money market.

The **National Bank of Ethiopia** (**NBE**) is the central bank of Ethiopia.

The bank is active in promoting financial inclusion policy and is a member of the Alliance for Financial Inclusion (AFI)

Following the proclamation the National Bank of Ethiopia was entrusted with the following responsibilities:

- To regulate the supply, availability and cost of money and credit.
- To manage and administer the country's international reserves.
- To license and supervise banks and hold commercial banks reserves and lend money to them.
- To supervise loans of commercial banks and regulate interest rates.
- To issue paper money and coins.
- To act as an agent of the Government.
- To fix and control the foreign exchange rates.

Non-banking financial companies (NBFCs) are entities or institutions that provide certain bank-like and financial services but do not hold a banking license, and so are unregulated by financial and state regulators.

2.4. Exercise

1. What is a banking system?
2. What is a commercial bank?
3. What is a central bank?
4. What are the services of Commercial banking?

CHAPTER THREE

3. BANKING AND THE MANAGEMENT OF FINANCIAL INSTITUTIONS

Introduction

A financial institution is an intermediary between consumers and the capital or the debt markets providing banking and investment services. A financial institution is responsible for the supply of money to the market through the transfer of funds from investors to the companies in the form of loans, deposits, and investments.

The most common types of financial institutions include commercial banks, investment banks, brokerage firms, insurance companies, and asset management funds. Other types include credit unions and finance firms. Financial institutions are regulated to control the supply of money in the market and protect consumers.

The most common types of financial institutions include commercial banks, investment banks, brokerage firms, insurance companies, and asset management funds. Other types include credit unions and finance firms. Financial institutions are regulated to control the supply of money in the market and protect consumers.

3.1. The Bank Balance Sheet

A balance sheet (aka statement of condition, statement of financial position) is a financial report that shows the value of a company's assets, liabilities, and owner's equity on a specific date, usually at the end of an accounting period, such as a quarter or a year. An asset is anything that can be sold for value. A liability is an obligation that must eventually be paid, and, hence, it is a claim on assets. The owner's equity in a bank is often referred to as bank capital, which is what is left when all assets have been sold and all liabilities have been paid. The relationship of the assets, liabilities, and owner's equity of a bank is shown by the following equation:

Bank Assets = Bank Liabilities + Bank Capital

A bank uses liabilities to buy assets, which earns its income. By using liabilities, such as deposits or borrowings, to finance assets, such as loans to individuals or businesses, or to buy interest earning securities, the owners of the bank can leverage their bank capital to earn much more than would otherwise be possible using only the bank's capital.

Assets and liabilities are further distinguished as being either current or long-term. Current assets are assets expected to be sold or otherwise converted to cash within 1 year; otherwise, the assets are long-term (aka noncurrent assets). Current liabilities are expected to be paid within 1 year; otherwise, the liabilities are long-term (aka noncurrent liabilities). Working capital is the excess of current assets over current liabilities, a measure of its liquidity, meaning its ability to meet short-term liabilities:

Working Capital = Current Assets – Current Liabilities

Generally, working capital should be sufficient to meet current liabilities. However, it should not be excessive, since capital in the form of long-term assets usually has a higher return. The excess of the bank's long-term assets over its long-term liabilities is an indication of its solvency, its ability to continue as a going concern.

3.2. General Principles of Bank Management

Bankers must manage their assets and liabilities to ensure three conditions:

Their bank has enough reserves on hand to pay for any deposit outflows (net decreases in deposits) *but not so many as to render the bank unprofitable*. This tricky trade-off is called liquidity management.

1. *Their bank earns profits*. To do so, the bank must own a diverse portfolio of remunerative assets. This is known as asset management. It must also obtain its funds as cheaply as possible, which is known as liability management.
2. *Their bank has sufficient net worth or equity capital to maintain a cushion against bankruptcy or regulatory attention but not so much that the bank is unprofitable*. This second tricky trade-off is called capital adequacy management.

In their quest to earn profits and manage liquidity and capital, banks face two major risks: credit risk, the risk of borrowers defaulting on the loans and securities it owns, and interest rate risk, the risk that interest rate changes will decrease the returns on its assets and/or increase the cost of its liabilities. The financial panic of 2008 reminded bankers that they also can face liability and capital adequacy risks if financial markets become less liquid or seize up completely (trading is greatly reduced or completely stops; q* approaches 0).

Asset management entails the usual trade-off between risk and return. Bankers want to make safe, high-interest rate loans but, of course, few of those are to be found. So they must choose between giving up some interest or suffering higher default rates. Bankers must also be careful to diversify, to make loans to a variety of different types of borrowers, preferably in different geographic regions. That is because sometimes entire sectors or regions go bust and the bank will too if most of its loans were made in a depressed region or to the struggling group. Finally, bankers must bear in mind that they need some secondary reserves, some assets that can be quickly and cheaply sold to bolster reserves if need be.

3.2.1. Liquidity Management and the Role of Reserves

Liquidity, or the ability to fund increases in assets and meet obligations as they come due, is crucial to the ongoing viability of any banking organization. Therefore, managing liquidity is among the most important activities conducted by banks. Sound liquidity management can reduce the probability of serious problems. Indeed, the importance of liquidity transcends the individual bank, since a liquidity shortfall at a single institution can have system-wide repercussion. For this reason, the analysis of liquidity requires bank management not only to measure the liquidity position of the bank on an ongoing basis but also to examine how funding requirements are likely to evolve under various scenarios, including adverse conditions.

What are the principal sources of liquidity demand for a financial firm?

The utmost demands for liquidity arise principally from customers withdrawing money from their deposits and from credit requests. However, demands for liquidity can also come from paying off previous borrowings, operating expenses and taxes incurred during operations and from payment of a cash dividend to stockholders also.

What are the principal sources from which the supply of liquidity comes?

Supplies of funds stem principally from incoming deposits, sales of assets, particularly marketable securities and repayments of outstanding loans. Liquidity also comes from the sale of non-deposit like remittance fee, bank counter guarantee fee services and borrowings from the money market.

When is a financial institution adequately liquid?

A financial institution is adequately liquid if it has adequate cash available precisely when cash is needed at a reasonable cost. Management can monitor the cash position over time, and also monitor what is happening to its cost of funds. One indicator of the adequacy of the liquidity position is its cost – a rising interest cost may reflect greater perceived risk for the borrowing bank as viewed by capital-market investors.

Why do financial firms face significant liquidity management problems?

Financial institutions are prone to liquidity management problems due to:

1. A maturity mismatch situation in which most depository institutions hold an unusually high proportion of liabilities subject to immediate payment, especially demand (checkable) deposits and money market borrowings;
2. The sensitivity of changes to their assets and liabilities values towards market interest-rate movements; and
3. Their central role in the payments process.

What are the principal differences among asset liquidity management, liability management, and balanced liquidity management?

Asset management is a strategy for meeting liquidity needs, used mainly by smaller banks, in which liquid funds are stored in readily marketable assets that can be quickly converted into cash as needed. Liability management involves borrowing enough immediately spendable funds to cover demands for liquidity made against a bank. Balanced liquidity management calls for using both asset management and liability management to cover a bank's liquidity needs. What guidelines should management keep in mind when it manages a financial firm's liquidity position?

It is important for a liquidity manager to: (a) keep track of the activities of other departments within the bank; (b) Know in advance the planned activities of the bank's largest credit and deposit customers; (c) set clear priorities and objectives in liquidity management; and (d) react quickly to liquidity deficits and liquidity surpluses.

Liquidity managers must know what other departments within the institution are doing because their activities affect the liquidity position and liquidity management decisions. The liquidity manager can make better decisions to profitably invest surplus liquid funds or avoid costly, last-minute borrowings if he or she knows what the bank's principal depositors and creditors will do in advance. By setting clear priorities and objectives the liquidity manager has a better chance to make sound decisions plus an ability to act quickly to invest surpluses in order to gain maximum income or avoid costly deficits and prolonged borrowings.

How do the sources and uses of funds approach help a manager estimate a financial institution's need for liquidity?

The sources and uses of funds approach estimates future deposit inflows and estimated outflows of funds associated with expected loan demand and calculates the net difference between these items in each planning period.

When sources and uses of liquidity do not match, there is a liquidity gap, measured by the size of the difference between sources and uses of funds. When sources of liquidity (e.g., increasing deposits or decreasing loans) exceed uses of liquidity (e.g., decreasing deposits or increasing loans) then the financial firm will have a positive liquidity gap (surplus). Its surplus liquid funds must be quickly invested in earning assets until they are needed to cover future cash needs. On the other hand, when uses exceed sources, a financial institution faces a negative liquidity gap (deficit). It now must raise funds from the cheapest and most timely sources available.

What steps are needed to carry out the structure of funds approach to liquidity management?

In the first step, the institution's deposits and other funds sources are divided into categories based upon their estimated probability of being withdrawn and, therefore, lost to the financial firm. Second, the liquidity manager must set aside liquid funds according to some desired operating rules for those categories. Categories can include "hot money" liabilities, vulnerable funds, and stable funds.

What is the liquidity indicator approach to liquidity management?

The liquidity indicator approach uses tell-tale financial ratios (e.g., total loans/total assets or cash assets/total assets) whose changes over time may reflect the changing liquidity position of the financial institution. The ratios are used to estimate liquidity needs and to monitor changes in the liquidity position.

How can the discipline of the marketplace be used as a guide for making liquidity management decisions?

No financial institution can tell for sure if it has sufficient liquidity until it has passed the market's test. Specifically, management should look at these signals: public confidence, stock price behavior, risk premiums on CDs and other borrowings, loss sales of assets, meeting commitments to credit customers and borrowings from the Federal Reserve banks. If problems exist in any of these areas, management needs to take a close look at its liquidity management practices to determine whether changes are in order.

What is money position management?

Money position management is the management of a financial institution's liquidity position that requires quick decisions which may have long-run consequences on profitability. Most large depository institutions have designated an officer of the firm as money position manager. A money position manager is responsible for ensuring that the institution maintains an adequate level of legal reserves. Legal reserve requirements apply to all qualified depository institutions, including commercial and savings banks, savings and loan associations, credit unions, and agencies and branches of foreign banks that offer transaction deposits or non-personal (business) time deposits or borrow through Eurocurrency liabilities.

What is the principal goal of money position management?

The money-position management's goal is to ensure that the bank has sufficient legal reserves to meet its reserve requirements as imposed by the central bank. Also make sure that it holds not more than the minimum legal requirement because excess legal reserves yield no income for the bank.

Exactly how is a depository institution's legal reserve requirement determined?

Each resolvable liability item is multiplied by the stipulated reserve requirement percentage set by the Federal Reserve Board to derive the bank's total legal reserve requirements. Thus, total required legal reserves equal the reserve requirement on transaction deposits times the daily average amount of net transaction deposits over a designated period plus the reserve requirement on non-transaction resolvable liabilities times the daily average amount of non-transaction resolvable liabilities. Currently no transaction liabilities have a reserve requirement of zero.

What factors should a money position manager consider in meeting a deficit in a depository institution's legal reserve account?

Several factors must be taken into account by the money position manager, including current and expected future levels of interest rates, projected changes in monetary policy, the bank's borrowing capacity and current holdings of liquid assets, the bank's forecast of future deposit growth and loan demand, the expected size and duration of any liquidity deficits or surpluses, and his or her knowledge of the future plans of the bank's largest depositors and borrowers with credit lines.

What are clearing balances? Of what benefit can clearing balances be to a depository that uses the Federal Reserve System's check-clearing network?

Any financial institution using the Federal Reserve check clearing system has to maintain a minimum balance with the Federal Reserve. The amount is determined by its estimated check clearing needs and its recent record of overdrafts. The clearing balance can be a benefit because the institution earns credits from holding this balance with the Fed and this credit can be used to pay the fees the Fed charges for services.

What are sweeps accounts? Why have they led to a significant decline in the total legal reserves held at the Federal Reserve banks by depository institutions operating in the United States?

A sweep account is a combination of two or more accounts at a bank or a financial institution. It is useful in managing a steady cash flow between a cash account used to make scheduled payments, and an investment account where the cash is able to accrue a higher return. A sweeps account is a service provided by banks where they sweep money out of accounts that carry reserve requirements (such as demand deposits and other checking accounts) into savings accounts which do not carry reserve requirements overnight. This service lowers the bank's overall cost of funds while still allowing the customer access to their deposits for payments. These sweep arrangements account for nearly (in US $200 billion) in deposit balances today and therefore have significantly reduced the total reserve requirements of banks.

3.2.2. Asset Management

Asset management refers to systematic approach to the governance and realization of value from the things that a group or entity is responsible for, over their whole life cycles. It may apply both to tangible assets (physical objects such as buildings or equipment) and to intangible assets (such as human capital, intellectual property, goodwill and/or financial assets). Asset management is a systematic process of developing, operating, maintaining, upgrading, and disposing of assets in the most cost-effective manner (including all costs, risks and performance attributes).

The term is commonly used in the financial sector to describe people and companies who manage investments on behalf of others. Those include, for example, investment managers that manage the assets of a pension fund. It is also increasingly used in both the business world and public infrastructure sectors to ensure a coordinated approach to the optimization of costs, risks, service/performance and sustainability. The International Standard, ISO 55000, provides an introduction and requirements specification for a management system for asset management.

The most common usage of the term "asset manager" refers to investment management, the sector of the financial services industry that manages investment funds and segregated client accounts. Asset management is part of a financial company which employs experts who manage money and handle the investments of clients. From studying the client's assets to planning and looking after the investments, all things are looked after by the asset managers and recommendations are provided based on the financial health of each client.

3.2.3. Liability Management

Liabilities are either the deposits of customers or money that banks borrow from other sources to use to fund assets that earn revenue. Deposits are like debt in that it is money that the banks owe to the customer but they differ from debt in that the addition or withdrawal of money is at the discretion of the depositor rather than dictated by contract.

Liability management is the practice by banks of maintaining a balance between the maturities of their assets and their liabilities in order to maintain liquidity and to facilitate lending while also maintaining healthy balance sheets.

What is Liability Management?

Liability management is the practice by banks of maintaining a balance between the maturities of their assets and their liabilities in order to maintain liquidity and to facilitate lending while also maintaining healthy balance sheets. In this context, liabilities include depositors’ money as well as funds borrowed from other financial institutions. A bank practicing liability management looks after these funds and also hedges against changes in interest rates.

3.2.4 Capital Adequacy Management

Capital adequacy management is a bank’s decision about the amount of capital it should maintain and then acquisition of the needed capital.

Capital Adequacy Ratio (CAR) is also known as Capital to Risk (Weighted) Assets Ratio (CRAR) is the ratio of a bank's capital to its risk. National regulators track a bank's CAR to ensure that it can absorb a reasonable amount of loss and complies with statutory Capital requirements.

3.3. Summary

The most common types of financial institutions include commercial banks, investment banks, brokerage firms, insurance companies, and asset management funds. Other types include credit unions and finance firms. Financial institutions are regulated to control the supply of money in the market and protect consumers.

A balance sheet (aka statement of condition, statement of financial position) is a financial report that shows the value of a company's assets, liabilities, and owner's equity on a specific date, usually at the end of an accounting period, such as a quarter or a year.

An asset is anything that can be sold for value.

A liability is an obligation that must eventually be paid, and, hence, it is a claim on assets. The owner's equity in a bank is often referred to as bank capital, which is what is left when all assets have been sold and all liabilities have been paid.

Asset management refers to systematic approach to the governance and realization of value from the things that a group or entity is responsible for, over their whole life cycles.

Liability management is the practice by banks of maintaining a balance between the maturities of their assets and their liabilities in order to maintain liquidity and to facilitate lending while also maintaining healthy balance sheets.

Capital adequacy management is a bank's decision about the amount of capital it should maintain and then acquisition of the needed capital.

3.4. Exercise

1. What are the principal sources of liquidity demand for a financial firm?
2. What are the principal sources from which the supply of liquidity comes?
3. What guidelines should management keep in mind when it manages a financial firm's liquidity position?

UNIT FOUR

4. ECONOMIC ANALYSIS OF BANKING REGULATION

Introduction

Bank regulation is a form of government regulation which subjects banks to certain requirements, restrictions and guidelines, designed to create market transparency between banking institutions and the individuals and corporations with whom they conduct business, among other things. As regulation focusing on key actors in the financial markets, it forms one of the three components of financial law, the other two being case law and self-regulating market practices.

Given; the interconnectedness of the banking industry and the reliance that the national (and global) economy hold on banks, it is important for regulatory agencies to maintain control over the standardized practices of these institutions. Another relevant example for the interconnectedness is that the law of financial industries or financial law focuses on the financial (banking), capital, and insurance markets. Supporters of such regulation often base their arguments on the "too big to fail" notion. This holds that many financial institutions (particularly investment banks with a commercial arm) hold too much control over the economy to fail without enormous consequences. This is the premise for government bailouts, in which government financial assistance is provided to banks or other financial institutions that appear to be on the brink of collapse. The belief is that without this aid, the crippled banks would not only become bankrupt, but would create rippling effects throughout the economy leading to systemic failure. Compliance with bank regulations is verified by personnel known as bank examiners.

4.1. Asymmetric Information and Banking Regulation

What Is Asymmetric Information?

Asymmetric information, also known as "information failure," occurs when one party to an economic transaction possesses greater material knowledge than the other party. This typically manifests when the seller of a good or service possesses greater knowledge than the buyer; however, the reverse dynamic is also possible. Almost all economic transactions involve information asymmetries.

Understanding Asymmetric Information

Asymmetric information is the specialization and division of knowledge, as applied to any economic trade. For example, doctors typically know more about medical practices than their patients. After all, physicians have extensive medical school educational backgrounds that their patients generally don't have. This principle equally applies to architects, teachers, police officers, attorneys, engineers, fitness instructors, and other trained professionals.

Asymmetric information isn't necessarily a bad thing. In fact, growing asymmetrical information is the desired outcome of a healthy market economy. As workers strive to become increasingly specialized in their chosen fields, they become more productive, and can consequently provide greater value to workers in other fields.

For example, a stockbroker's knowledge is more valuable to a non-investment professional, such as a farmer, who may be interested in confidently trading stocks, to prepare for retirement.

One alternative to ever-expanding asymmetric information is for workers to study all fields, rather than specialize in fields where they can provide the most value. However, this is an impractical solution, with high opportunity costs and potentially lower aggregate outputs, which would lower standards of living.

Another alternative to asymmetric information is to make information abundantly and inexpensively available through the internet and other data sources.

The Disadvantages of Asymmetric Information

In some circumstances, asymmetric information may have near fraudulent consequences, such as adverse selection, which describes a phenomenon where an insurance company encounters the probability of extreme loss due to a risk that was not divulged at the time of a policy's sale.

For example, if the insured hides the fact that he's a heavy smoker and frequently engages in dangerous recreational activities, this asymmetrical flow of information constitutes adverse selection and could raise insurance premiums for all customers, forcing the healthy to withdraw.

The solution is for life insurance providers is to perform thorough actuarial work and conduct detailed health screenings, and then charge different premiums to customers based on their honestly-disclosed risk profiles.

Key Takeaways

- Asymmetric information, also known as "information failure," occurs when one party to an economic transaction possesses greater material knowledge than the other party.

- Asymmetric information typically manifests when the seller of a good or service possesses greater knowledge than the buyer; however, the reverse dynamic is also possible. Almost all economic transactions involve information asymmetries.

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4.2. Restrictions on Asset Holdings and Bank Capital Requirements

One way to prevent bank from engaging in risky behavior is to restrict what sort of assets they can own. After the Great Depression they have been restricted to owning government securities (very liquid with almost no default risk) and loans. Bank regulations have also been applied to loans. Bank were required to diversity their loan portfolio. Banks usually were not allowed to make very large loans to individuals or make certain types of loans.

Banks were also required to have a certain amount of capital. This is what the bank owners will lose if the bank fails. It is hoped this will encourage the bank owners to hire good managers. Bank capital leverage ratio total assets=A bank is considered to be well leveraged if the leverage ratio exceeds 5%. If the ratio falls below 3% this will trigger increased restriction on the bank, off balance sheet activities banks are generating more income from fees and financial instrument trading that do not show up on the banks' balance sheet. These activities expose the banks to risk. This has led to an additional capital requirement over and above the leverage ratio. The purpose of this requirement is to ensure that the owners will monitor the off balance sheet activities (This is an international requirement to ensure that banks from different countries can be competitive internationally.

Bank supervision

While individual depositors can't afford to monitor a banks activity the government provides that service by bank supervision (also called prudential supervision). A bank would be a very useful tool for crooks (money laundering, financing of operations, etc). It could also provide a ready source of funding to individuals who would be willing to engage in very risky schemes. Chartering is one mechanism used to prevent this. Chartering deals with the adverse Selection problem.

4.3. Assessment of Risk Management

Risk assessment is a term used to describe the overall process or method where you: Identify hazards and risk factors that have the potential to cause harm (hazard identification). Analyze and evaluate the risk associated with that hazard (risk analysis, and risk evaluation).

In assessment of risk management

- Greater emphasis on evaluating soundness of management processes for controlling risk
- Trading Activities Manual of 1994 for risk management rating based on:
- Quality of oversight provided
- Adequacy of policies and limits for all risky activities

The bank examination traditionally had focused on whether the bank was in compliance with bank regulations at the time of the examination (adequate reserves, adequate capital, and restrictions on asset holdings). Recently more attention is being paid to how a bank is likely to be operating in the future. The Baring bank failure showed how a bank could be sound at one time but quickly become insolvent. Bank examination now includes:

- The quality of oversight provided by the board of directors and senior management
- The adequacy of policies and limits for all activities that present significant risk
- The quality of risk measurement and monitoring systems.
- The adequacy of internal controls

Disclosure requirements

Banks are required to follow standard accounting practices and report certain information regarding its asset portfolio and exposure to risk. This report is available to the banking public. This provides stockholders, depositors and creditors with a means of monitoring the bank Consumer protection. “Truth in lending” provisions in loan contracts

The Fair Credit Billing Act requires credit card companies to explain finance charges and settle billing complaints. It also prevents discrimination.

Restrictions on competition

Competition can increase moral hazard incentives for banks to take more risk. We have seen restrictions on branch banking and Regulation Q. Also there were restrictions preventing nonblank institutions from engaging in banking.

Restrictions on Asset Holdings

- Attempts to restrict financial institutions from too much risk taking:
- Bank regulations
- Promote diversification
- Prohibit holdings of common stock
- Capital requirements
- Minimum leverage ratio (for banks)
- Basel Accord: risk-based capital requirements
- Regulatory arbitrage

Capital Requirements

Government-imposed capital requirements are another way of minimizing moral hazard at financial institutions

There are two forms:

1. Based on the leverage ratio, the amount of capital divided by the bank’s total assets: to be classified as well capitalized, a bank’s leverage ratio must exceed 5%; a lower leverage ratio, especially one below 3%, triggers increased regulatory restrictions on the bank
2. Risk-based capital requirements

Financial Supervision: Chartering and Examination

1. Chartering (screening of proposals to open new financial institutions) to prevent adverse selection
2. Examinations (scheduled and unscheduled) to monitor capital requirements and restrictions on asset holding to prevent moral hazard
    - Capital adequacy
    - Asset quality
    - Management
    - Earnings
    - Liquidity
    - Sensitivity to market risk
3. Filing periodic ‘call reports’

What is a Risk Management Assessment and what does it entail?

The Risk Management Assessment, or RMA, is the first step in developing a comprehensive risk management program. The RMA identifies, analyzes, and reports on an organization’s material risk exposures. It provides a multi-dimensional view of risk, taking into account organization-wide enterprise risks and specific insurance-related exposures. A typical Risk Management Assessment consists of five steps, they are:

Get to know the organization.

Gather as much information as possible to learn about the organization, establish objectives, and review a timeline for completion of the RMA.

Examine risk management techniques.

Take a closer look at the existing insurance coverage, what losses have been experienced, and the organization’s Total Cost of Risk (TCoR), as well as the risk management best practices currently in use.

Identify and analyze exposures.

Ask a series of questions designed to uncover risk exposures and prepare an action plan to protect against these risks.

Implement the plan.

Address gaps in insurance, finalize loss reserve reviews and procedures and set a strategy for improvement.

Monitor results and provide support. Form a work group with members from the organization and provide ongoing guidance on risk-related issues. Recommend actions that the support continual TCOR improvements

Working with the senior management team, the risk management consultants will:

- Gain a thorough understanding of the organization and business model, including competitors, supply chain, production and distribution risks.
- Consider strategic drivers and any obstacles that might impact achieving long- and short-term goals.
- Identify and analyze operational exposures to evaluate the level of materiality the company can absorb.
- Evaluate existing risk management practices and insurance programs

What sort of information is reviewed?

- Insurance policies, specifically gaps and weaknesses
- Unique, business-specific risk exposures
- Past losses --- Are reserves sufficient?
- Premiums --- Are they competitive when benchmarked against competitors' rates?
- Best practices --- What is the organization currently doing to minimize risk?
- Contracts --- are obligations broader than your insurance?

4.4. Political Economy of the Savings and Loan Crisis

The savings and loan (S&L) crisis was a slow-moving financial disaster.
A savings and loan or "thrift" is a financial institution that accepts savings deposits and makes mortgage, car and other personal loans to individual members.

4.5. The Financial Institutions Reform

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), is a United States federal law enacted in the wake of the savings and loan crisis of the 1980s. It established the Resolution Trust Corporation to close hundreds of insolvent thrifts and provided funds to pay out insurance to their depositors. It transferred thrift regulatory authority from the Federal Home Loan Bank Board to the Office of Thrift Supervision.[citation needed] It dramatically changed the savings and loan industry and its federal regulation, encouraging loan origination.
Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) — a 1989 law passed in response to a series of savings and loan failures during the 1980s. The Act provides a comprehensive regulatory and enforcement apparatus that establishes higher minimum capital requirements and sets stricter operating standards for all savings institutions. Among other provisions, FIRREA imposes a three-tier schedule of civil monetary penalties that may be assessed against institutions and their directors and officers for breaches of fiduciary duty. FIRREA also grants regulatory agencies the power to disapprove a "troubled" savings institution's appointment of any director or senior executive officer and to remove or suspend any director or officer found guilty of certain specified acts. FIRREA also holds directors and officers of savings institutions personally liable for monetary damages in civil actions brought by regulatory agencies in cases of gross negligence.

4.6. Summary

Bank regulation is a form of government regulation which subjects banks to certain requirements, restrictions and guidelines, designed to create market transparency between banking institutions and the individuals and corporations with whom they conduct business, among other things. As regulation focusing on key actors in the financial markets, it forms one of the three components of financial law, the other two being case law and self-regulating market practices.

Asymmetric information, also known as "information failure," occurs when one party to an economic transaction possesses greater material knowledge than the other party. This typically manifests when the seller of a good or service possesses greater knowledge than the buyer; however, the reverse dynamic is also possible. Almost all economic transactions involve information asymmetries.

Asymmetric information is the specialization and division of knowledge, as applied to any economic trade. For example, doctors typically know more about medical practices than their patients.

Asymmetric information isn't necessarily a bad thing. In fact, growing asymmetrical information is the desired outcome of a healthy market economy.

In some circumstances, asymmetric information may have near fraudulent consequences, such as adverse selection, which describes a phenomenon where an insurance company encounters the probability of extreme loss due to a risk that was not divulged at the time of a policy's sale. Government-imposed capital requirements are another way of minimizing moral hazard at financial institutions

There are two forms of Capital Requirements:

1. Based on the leverage ratio, the amount of capital divided by the bank's total assets: to be classified as well capitalized, a bank's leverage ratio must exceed 5%; a lower leverage ratio, especially one below 3%, triggers increased regulatory restrictions on the bank.
2. Risk-based capital requirements

The Risk Management Assessment, or RMA, is the first step in developing a comprehensive risk management program.

4.7. Exercise

1. Define Risk Assessment?
2. A typical Risk Management Assessment consists of five steps, they are:

CHAPTER FIVE

5. NONBANK FINANCE

Introduction

Non-banking financial companies (NBFCs) are entities or institutions that provide certain bank-like and financial services but do not hold a banking license. ... Investment banks, mortgage lenders, money market funds, insurance companies, hedge funds, private equity funds, and P2P lenders are all examples of NBFCs.

5.1. Insurance

Insurance is a means of protection from financial loss. It is a form of risk management, primarily used to hedge against the risk of a contingent or uncertain loss.

An entity which provides insurance is known as an insurer, insurance company, insurance carrier or underwriter. A person or entity who buys insurance is known as an insured or as a policyholder. The insurance transaction involves the insured assuming a guaranteed and known relatively small loss in the form of payment to the insurer in exchange for the insurer's promise to compensate the insured in the event of a covered loss. The loss may or may not be financial, but it must be reducible to financial terms, and usually involves something in which the insured has an insurable interest established by ownership, possession, or pre-existing relationship.

The insured receives a contract, called the insurance policy, which details the conditions and circumstances under which the insurer will compensate the insured. The amount of money charged by the insurer to the policyholder for the coverage set forth in the insurance policy is called the premium. If the insured experiences a loss which is potentially covered by the insurance policy, the insured submits a claim to the insurer for processing by a claims adjuster. The insurer may hedge its own risk by taking out reinsurance, whereby another insurance company agrees to carry some of the risk, especially if the primary insurer deems the risk too large for it to carry.

In insurance, the insurance policy is a contract (generally a standard form contract) between the insurer and the insured, known as the policyholder, which determines the claims which the insurer is legally required to pay. In exchange for an initial payment, known as the premium, the insurer promises to pay for loss caused by perils covered under the policy language.

Insurance contracts are designed to meet specific needs and thus have many features not found in many other types of contracts. Since insurance policies are standard forms, they feature boilerplate language which is similar across a wide variety of different types of insurance policies.

The insurance policy is generally an integrated contract, meaning that it includes all forms associated with the agreement between the insured and insurer. In some cases, however, supplementary writings such as letters sent after the final agreement can make the insurance policy a non-integrated contract. One insurance textbook states that generally "courts consider all prior negotiations or agreements ... every contractual term in the policy at the time of delivery, as well as those written afterward as policy riders and endorsements ... with both parties' consent, are part of the written policy". The textbook also states that the policy must refer to all papers which are part of the policy. Oral agreements are subject to the parol evidence rule, and may not be considered part of the policy if the contract appears to be whole. Advertising materials and circulars are typically not part of a policy.] Oral contracts pending the issuance of a written policy can occur.

The insurance contract or agreement is a contract whereby the insurer promises to pay benefits to the insured or on their behalf to a third party if certain defined events occur. Subject to the "fortuity principle", the event must be uncertain. The uncertainty can be either as to when the event will happen (e.g. in a life insurance policy, the time of the insured's death is uncertain) or as to if it will happen at all (e.g. in a fire insurance policy, whether or not a fire will occur at all).

Insurance contracts are generally considered contracts of adhesion because the insurer draws up the contract and the insured has little or no ability to make material changes to it. This is interpreted to mean that the insurer bears the burden if there is any ambiguity in any terms of the contract. Insurance policies are sold without the policyholder even seeing a copy of the contract. In 1970 Robert Keeton suggested that many courts were actually applying 'reasonable expectations' rather than interpreting ambiguities, which he called the 'reasonable expectations doctrine'. This doctrine has been controversial, with some courts adopting it and others explicitly rejecting it. In several jurisdictions, including California, Wyoming, and Pennsylvania, the insured is bound by clear and conspicuous terms in the contract even if the evidence suggests that the insured did not read or understand them.

Insurance contracts are aleatory in that the amounts exchanged by the insured and insurer are unequal and depend upon uncertain future events. In contrast, ordinary non-insurance contracts are commutative in that the amounts (or values) exchanged are usually intended by the parties to be roughly equal. This distinction is particularly important in the context of exotic products such as finite risk insurance that contain "commutation" provisions.

Insurance contracts are unilateral, meaning that only the insurer makes legally enforceable promises in the contract. The insured is not required to pay the premiums, but the insurer is required to pay the benefits under the contract if the insured has paid the premiums and met certain other basic provisions.

Insurance contracts are governed by the principle of utmost good faith (uberrima fides), which requires both parties of the insurance contract to deal in good faith and in particular, imparts on the insured a duty to disclose all material facts that relate to the risk to be covered. This contrasts with the legal doctrine that covers most other types of contracts, caveat emptor (let the buyer beware). In the United States, the insured can sue an insurer in tort for acting in bad faith.

5.2. Pension Funds

Pension funds are investment pools that pay for employee retirement commitments. Funds are paid for by either employees, employers, or both. Corporations and all levels of government provide pensions. The fund managers invest these contributions conservatively. They must avoid losing the principal but still beat inflation.

Types: There are two types of pension funds. The first is the Defined Benefit fund. It's obligated to pay a fixed income to the beneficiary, regardless of how well the fund does. The employee pays a fixed amount to the fund. The fund manager must receive enough of a return on the investment to pay for the benefits. The employer must pay for any shortfall.

Employers assume the funds will return 7 to 8 percent annually. That's their historical average. Actual returns are only 6 to 7 percent. As a result, most employers aren't contributing enough for future payouts.

The Defined Benefit pension fund is what most people think of when they say "pensions." You receive the same guaranteed amount. It's like an annuity provided by an insurance company. In this case, the employer functions as the insurance company and sustains all the risk if the market drops.

U.S. pension funds are either single-employer or multi-employer. The muti-employer plans allow small companies to band together to create diversified pensions. Employees benefit from being able to change companies without losing their pension benefits. There are 10 million current and retired workers in multi-employer plans. Many of them will probably run out of funds.

Benefits of these plans are guaranteed by the federal government's Pension Benefit Guaranty Corporation. The PBGC guarantees the pension incomes for 44.1 million workers in over 30,000 pension plans.

The second type is a Defined Contribution fund. The employee's benefits depend on how well the fund does. The most common of these are 401(k)s. The employer doesn't have to pay out defined benefits if the fund drops in value. All the risk is transferred to the employee. The shift in risk is the most important difference between the defined benefit and the defined contribution plan.

5.3. Mutual Funds and Internet

The Internet Fund is classified as a non-diversified fund. Therefore, the value of its shares may fluctuate more than shares invested in a broader range of industries. You should consult the Fund's prospectus for a complete list of risks associated with your investment.

Internet Fund is:

A fund that invests in undervalued companies participating in the growth of the Internet.

Focused not only on investing in traditional technology companies, but also those that provide new kinds of services or products made possible by development or improvement of Internet-related technologies within a variety of sectors.

Favor companies with strong alignment of interest and high barriers to entry, such as growing information library, scalability and network/adoption.

A fund that invests in undervalued companies participating in the growth of the Internet. ... Favor companies with strong alignment of interest and high barriers to entry, such as growing information library, scalability and network/adoption.

A mutual fund is a company that pools money from many investors and invests the money in securities such as stocks, bonds, and short-term debt. The combined holdings of the mutual fund are known as its portfolio. Investors buy shares in mutual funds.

A mutual fund is a type of financial vehicle made up of a pool of money collected from many investors to invest in securities like stocks, bonds, money market instruments, and other assets.

Mutual funds are operated by professional money managers, who allocate the fund's assets and attempt to produce capital gains or income for the fund's investors. A mutual fund's portfolio is structured and maintained to match the investment objectives stated in its prospectus.

Mutual funds give small or individual investors access to professionally managed portfolios of equities, bonds, and other securities. Each shareholder, therefore, participates proportionally in the gains or losses of the fund. Mutual funds invest in a vast number of securities, and performance is usually tracked as the change in the total market cap of the fund—derived by the aggregating performance of the underlying investments.

Key Takeaways

- A mutual fund is a type of investment vehicle consisting of a portfolio of stocks, bonds, or other securities.
- Mutual funds give small or individual investors access to diversified, professionally managed portfolios at a low price.
- Mutual funds are divided into several kinds of categories, representing the kinds of securities they invest in, their investment objectives, and the type of returns they seek.
- Mutual funds charge annual fees (called expense ratios) and, in some cases, commissions, which can affect their overall returns.
- The overwhelming majority of money in employer-sponsored retirement plans goes into mutual funds.

Understanding Mutual Funds

Mutual funds pool money from the investing public and use that money to buy other securities, usually stocks and bonds. The value of the mutual fund company depends on the performance of the securities it decides to buy. So, when you buy a unit or share of a mutual fund, you are buying the performance of its portfolio or, more precisely, a part of the portfolio's value. Investing in a share of a mutual fund is different from investing in shares of stock. Unlike stock, mutual fund shares do not give its holders any voting rights. A share of a mutual fund represents investments in many different stocks (or other securities) instead of just one holding.

5.4. Summary

The Internet Fund is classified as a non-diversified fund.

Internet Fund is:

- a fund that invests in undervalued companies participating in the growth of the Internet.

- Focused not only on investing in traditional technology companies, but also those that provide new kinds of services or products made possible by development or improvement of Internet-related technologies within a variety of sectors.
- A **mutual fund** is a company that pools money from many investors and invests the money in securities such as stocks, bonds, and short-term debt.

  Investors buy shares in **mutual funds**.

  Mutual funds give small or individual investors access to professionally managed portfolios of equities, bonds, and other securities.

- ✓ Mutual funds give small or individual investors access to diversified, professionally managed portfolios at a low price.
- ✓ Mutual funds are divided into several kinds of categories, representing the kinds of securities they invest in, their investment objectives, and the type of returns they seek.
- ✓ Mutual funds charge annual fees (called expense ratios) and, in some cases, commissions, which can affect their overall returns.
- ✓ The overwhelming majority of money in employer-sponsored retirement plans goes into mutual funds.

Mutual funds pool money from the investing public and use that money to buy other securities, usually stocks and bonds.

5.5. Exercise

1. What is a mutual fund?
2. What is Insurance?
3. What are Pension funds ?

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