Chapter 10

Commercial Banks: Industry Overview

Commercial Banks

- **Commercial banks** are the largest group of financial institutions in terms of total assets
- Major assets are loans
- Major liabilities are federally insured deposits—thus, they are considered **depository institutions**
- Perform services essential to U.S. financial markets
  - play a key role in the transmission of monetary policy
  - provide payment services
  - provide maturity intermediation
- Banks are regulated to protect against disruptions to the services they perform and to protect government insured deposits

Commercial Bank Assets

- **Loans** generate the most revenue for banks
  - commercial and industrial loans are declining because of nonbank substitutes such as commercial paper
  - mortgages have increased in importance over long term
- **Investment securities** generate revenue and provide banks with liquidity
- **Cash assets** are held to meet reserve requirements and to provide liquidity
- **Other assets** include premises and equipment, other real estate owned, etc.

Commercial Bank Assets

- (Across all bank sizes)
- The four main categories of assets are Cash, Investments, Loans & Other Assets
- Total loans fell as a result of the financial crisis, safe investments and cash rose
- Real Estate loans are about 50.5% of loans

	March 2014 (Bill $)		Percent
Total Cash Assets		$1,740.92	12.57%
Investments			
Securities	2,767.99		
Fed Funds & Rev. repos	414.00		
Total Investments		$3,181.99	22.97%
Loans			
Commercial & Industrial	1,554.72		
Real Estate	3,620.44		
Individual	1,224.14		
All other	896.81		
Less Reserve for loan losses	-122.89		
Unearned Income	-1.45		
Net Loans		$7,171.77	51.76%
Other Assets		$1,760.00	12.70%
Total Assets		$13,854.68	100.00%

Commercial Bank Assets

- Commercial banks face unique risks because of their asset structure
  - **credit (default) risk** is the risk that loans are not repaid
  - **liquidity risk** is the risk that depositors will demand more cash than banks can immediately provide
  - **interest rate risk** is the risk that interest rate changes erode profitability or net worth
  - credit, liquidity, and interest rate risk all contribute to a commercial bank’s level of **insolvency risk**

Commercial Bank Liabilities

- **Transaction accounts** are the sum of noninterest-bearing demand deposits and interest-bearing checking accounts
  - Transaction accounts are about 17.58% of deposits
  - Checkable interest-bearing deposit accounts are called **negotiable order of withdrawal (NOW) accounts**
- **Household (retail) savings and time deposits** have been declining in recent years because of MMMFs
  - passbook savings accounts
  - retail time deposits
- **Large time deposits**
  - negotiable CDs are fixed-maturity interest-bearing deposits with face values of $100,000 or more that can be resold in the secondary market

Commercial Bank Liabilities & Equity

- **Non-deposit liabilities**
  - fed funds purchased
  - repos
  - notes and bonds
- Minimum levels of **equity** capital are required by regulators to act as a buffer against losses
  - common and preferred stock
  - surplus or additional paid-in capital
  - retained earnings

Commercial Bank Liabilities & Equity

- (Across all bank sizes)
- Deposits are the main source of funds
- Equity has increased since the financial crisis and is now over 11% of assets
- The TARP program resulted in capital injections into banks of $386 billion

		Mar-14	
Liabilities and Equity		(Bill $)	Percent
Deposits			
Domestic	$9,120.42		
Foreign	$1,395.61		
Total Deposits		$10,516.03	75.90%
Fed Funds & Repos		$357.45	2.58%
Other borrowed funds		$1,422.06	10.26%
Total liabilities		$12,295.54	88.75%
Equity		$1,559.19	11.25%
Total liabilities and Equity		$13,854.73	100.00%

Off-Balance-Sheet Activities

- Commercial banks engage in many fee-related activities that are conducted off the balance sheet
  - guarantees such as letters of credit
  - future commitments to lend
  - derivative transactions (e.g., futures, forwards, options, and swaps)
- **Off-balance-sheet assets**
  - when an event occurs, this item moves onto the asset side of the balance sheet or income is realized on the income statement
- **Off-balance-sheet liabilities**
  - when an event occurs, this item moves onto the liability side of the balance sheet or an expense is realized on the income statement

Commercial Banks

- The **Reigle-Neal Act** of 1994 allowed nationwide branch networks to evolve
  - 14,483 banks with some 60,000 branches in 1984
  - 6,048 banks with some 83,000 branches in 2013
- The **Financial Services Modernization Act** of 1999
  - gave commercial banks the full authority to enter the investment banking and insurance business
- **Industrial loan corporations (ILCs)** are considered "non-bank" banks

Commercial Banks

- **Retail banking** is consumer-oriented
  - residential and consumer loans are funded by accepting small deposits
  - **community banks** specialize in retail banking
- **Wholesale banking** is business-oriented
  - commercial and industrial loans are often funded with purchased funds
  - **regional or superregional banks** engage in a complete array of wholesale banking activities
  - **money center banks** rely heavily on nondeposit or borrowed sources of funds, often borrowed in the **federal funds market**

Commercial Banks Performance Measures

- **Interest rate spread** is the difference between lending and deposit rates
- **Net interest margin** is interest income minus interest expense divided by earning assets
- **Net non-interest margin** is non-interest income minus non-interest expense divided by earning assets
- **Net Charge-Offs** is percent of loans written-off as uncollectable
- **Return on assets** is net income divided by assets
- **Return on equity** is net income divided equity

Commercial Bank Size & Performance

- Because larger banks generally lend to larger corporations, with more funding options larger banks often are required to have lower interest rate spreads and net interest margins than those of smaller banks
- Large banks tend to pay higher salaries and invest more in buildings and premises than small banks
- Large banks tend to diversify their operations more and generate more noninterest income than small banks

Commercial Bank Size Distribution

Summary of Text Figure 11-6

Size & Type 2013	% of total # banks	% of total banks assets
Community banks	91.1%	8.8%
\$1-10 billion	7.4%	8.6%
≥ \$10 billion	1.5%	82.6%
	100.0%	100.0%

About 1.5% of the largest banks control about 83% of industry assets.

Industry Performance

- U.S. commercial banks flourished during the economic expansion of the 1990s
- The economic downturn of the early 2000s caused performance to deteriorate only slightly
- By 2003 ROA and ROE had reached all-time highs
- In the fourth quarter of 2006, mortgage delinquencies (particularly subprime mortgages) surged
- Losses from falling values of subprime mortgages caused fourth quarter 2007 net income to hit a 16-year low

Industry Performance

- In 2008 ROA was a poor 0.13%, it fell again in 2009 to 0.09% before rising to 0.60% in 2010
- Similarly, ROE was 1.33% in 2008, 0.85% in 2009, and 5.44% in 2010
- The problem was not in interest spreads as the net interest margin remained high throughout the period (3.87% in 2010)
- Problems remained in credit losses

Industry Performance

- The long run of low interest rates has allowed banks to book good profits unrelated to credit losses
- Growth in non-interest income, low levels of non-interest expense, and low securities losses all contributed to strong profitability in 2013
- The number of bank failures and ‘problem banks’ continues to fall

Industry Performance

Performance Summary 2013						
Category	2013	Change from 2012		Category	2013	Change from 2012
Yield on earning assets	3.65%	Increase		Net Interest Margin	3.25%	Stable
Return on assets	1.06%	Increase		Return on Equity	9.57%	Increase
Net loans & leases to deposits	68.5%	Stable		Equity/Assets	11.11%	Stable

Regulators

- The **Federal Deposit Insurance Corporation (FDIC)** insures the deposits of commercial banks
- The U.S. has a **dual banking system**—banks can be either nationally or state-chartered
  - the **Office of the Comptroller of the Currency (OCC)** charters and regulates national banks
  - state agencies charter and regulate state banks
- **The Federal Reserve System (FRS)** has regulatory power over nationally chartered banks and their holding companies and state banks that opt in to the Federal Reserve System
  - a **holding company** is a parent company that owns a controlling interest in a subsidiary bank or other FI

International Commercial Banking

TABLE 11–5 The 20 Largest (in Total Assets) Banks in the World *(in billions of dollars)*

Bank	Country	Total Assets
1. Industrial Commercial Bank of China	China	$2,789
2. Mitsibushi UJF Financial Group	Japan	2,709
3. HSBC Holdings	United Kingdom	2,693
4. Deutsche Bank	Germany	2,655
5. Crédit Agricole	France	2,649
6. BNP Paribas	France	2,516
7. J. P. Morgan Chase	United States	2,359
8. Barclays Bank	United Kingdom	2,351
9. China Construction Bank Corp.	China	2,221
10. Bank of America	United States	2,212
11. Agricultural Bank of China	China	2,106
12. Royal Bank of Scotland	United Kingdom	2,070
13. Mizuho Financial Group	Japan	2,050
14. Bank of China	China	2,016
15. Citigroup	United States	1,865
16. Sumitomo Mitsui Financial	Japan	1,718
17. Banco Santander	Spain	1,675
18. Société Generale	France	1,650
19. Groupe BPCE	France	1,514
20. Lloyds Banking Group	United Kingdom	1,458

Source: Author's research.

How many U.S. banks are on this list? Why?

International Commercial Banking

- Advantages of international expansion:
  - risk diversification
  - economies of scale
  - distribute new product innovations internationally
  - opportunity to find the cheapest and most available sources of funds
  - service the needs of domestic multinational corporations
  - regulatory avoidance

International Commercial Banking

- Disadvantages of international expansion
  - information and monitoring costs are generally higher in foreign markets
  - foreign assets may be subject to nationalization or expropriation by host country governments
  - the fixed costs of establishing foreign organizations may be extremely high

Global Banking Performance

- Banks in most regions of the world posted strong performance in the early and mid-2000s but suffered from the financial crisis in the U.S. and later from the European debt crisis
- Large banks in the UK, Ireland, the Netherlands, Switzerland, Iceland, and Spain recorded annual losses during the crisis
- Led to sovereign debt problems in Europe with continued subpar growth in Europe