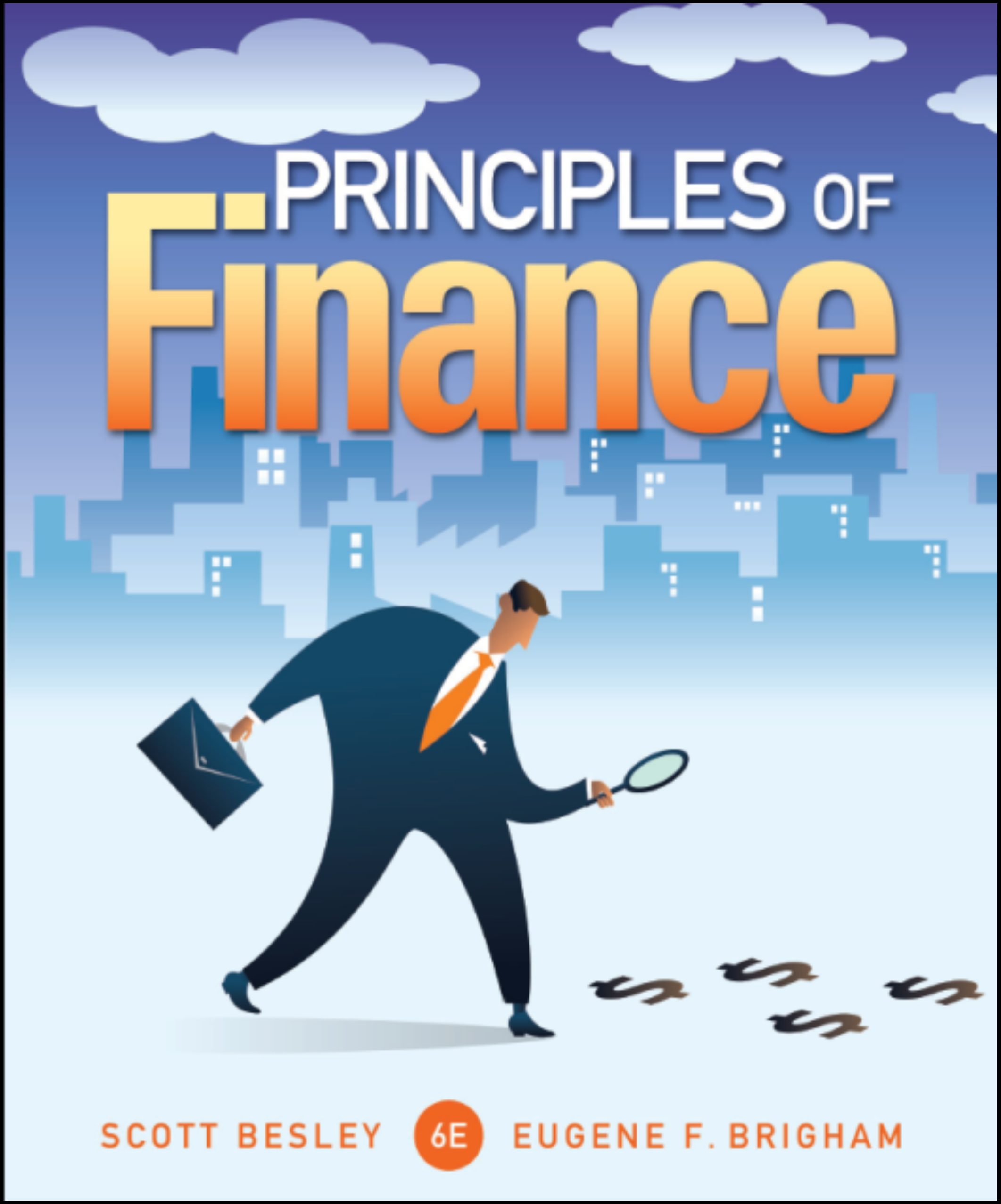


Chapter 4

Financial Intermediaries and the Banking System

Chapter 4- Learning Objectives

- ✓ Explain what a financial intermediary is and why so many different types of financial intermediaries exist.
- ✓ Describe the functions financial intermediaries perform.
- ✓ Describe a fractional reserve system.
- ✓ Describe the major characteristics of the U.S. banking system.
- ✓ Explain the function of the Federal Reserve.
- ✓ Explain how banks in the United States differ from banks in other countries.

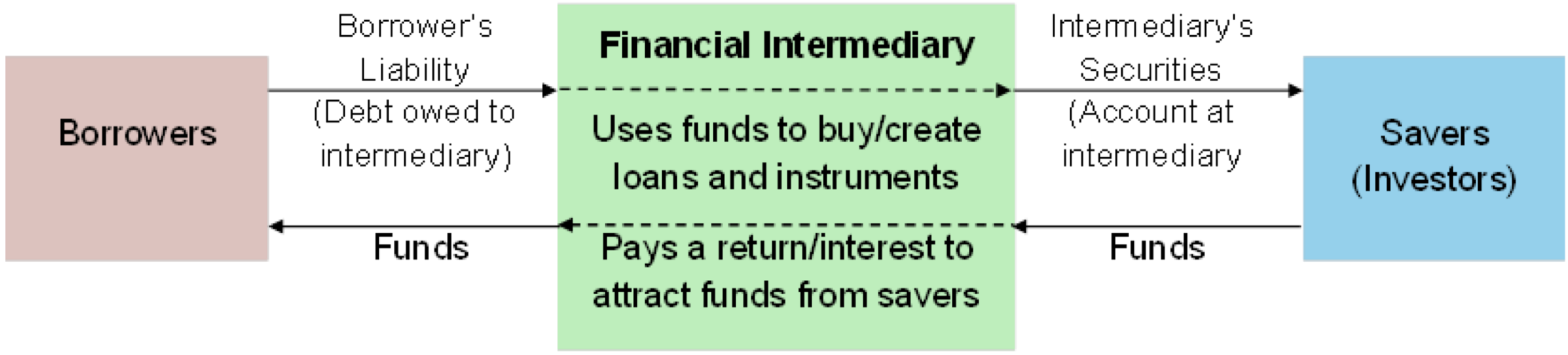
Financial Intermediaries

- ✓ Specialized financial firms that facilitate the indirect transfer of funds from savers to borrowers by offering savings instruments and borrowing instruments

Financial Intermediation

- ✓ The process by which financial intermediaries transform funds provided by savers into funds used by borrowers

The Financial Intermediation Process



Benefits of Intermediaries

1. Reduced costs
2. Risk/diversification
3. Funds divisibility/pooling
4. Financial flexibility
5. Related services

Types of Intermediaries

- ✓ Commercial banks
- ✓ Credit unions
- ✓ Thrift institutions (savings & loans)
- ✓ Mutual funds
- ✓ Whole life insurance companies
- ✓ Pension funds

Safety (Risk) of Financial Institutions

- Banks, thrifts and credit unions
  - Insured by FDIC
  - Regulated by Federal Reserve and Office of Thrift Supervision or NCUA
- Insurance companies
  - Regulated by states
- Pensions
  - ERISA established PBGC
- Mutual funds
  - SEC

Evolution of Banking Systems

- Storage of valuables (gold & silver)
- Depository receipts
- Receipts could be traded like modern money
- Inventory could be lent out
- Only necessary to maintain enough reserves to cover demand for withdrawal (fractional reserves)

Fractional Reserve System

- ✓ When the amount of reserves maintained by a financial institution to satisfy requests for withdrawals is less than 100 percent of total deposits

Excess Reserves

- ✓ Reserves at a bank in excess of the amount required
- ✓ Equal to the total reserves minus the required reserves
- ✓ Available for lending
  - ✓ An increase in reserves increases the money supply

Money Supply

- Maximum change in the money supply equals the excess reserves divided by the reserve requirement

$$\text{Maximum change in } M_S = \frac{\text{Excess reserves}}{\text{Reserve requirements}}$$

U. S. Banking System

- Dual banking system
  - Banks are chartered either at the state or the national level
- Intrastate branching
  - Establishing branch banks within the same state
- Interstate branching
  - Establishing branch banks in more than one state (across state lines)

Bank Holding Company

- Corporation that owns controlling interest in one or more banks

Central Banking –
The Federal Reserve System

- ✓ Manages the monetary policy of the country
- ✓ Decentralized network of regional, district banks
- ✓ Supervised by the Board of Governors, who are appointed by the President

Responsibilities of the Fed

- Monetary Policy of the U.S.
  - To promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates

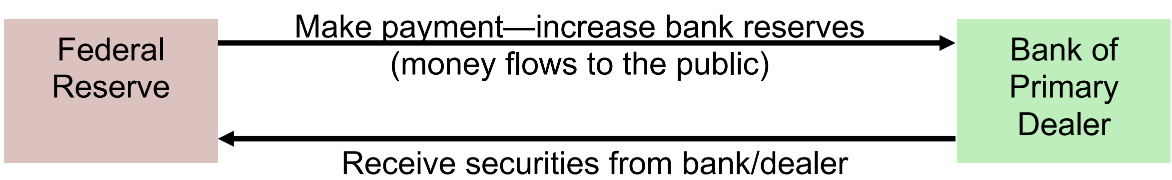
Monetary Policy

- Open Market Operations
  - Buy and sell Treasury securities to expand or contract the nation's money supply
- Primary Dealer
  - Has established relationship with the Federal Reserve to buy and sell government securities

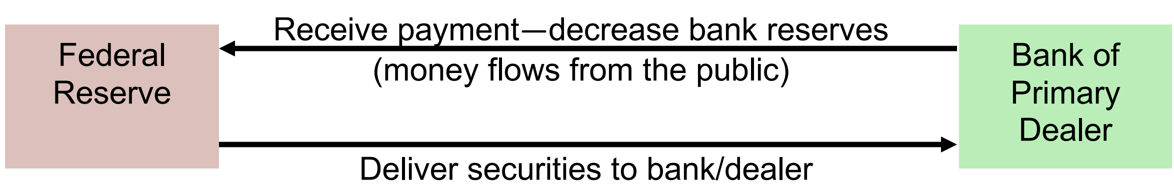
Monetary Policy

✓ Change Money Supply

✓ Increase M_s—buy securities from dealers



✓ Decrease M_s—sell securities to dealers



Monetary Policy

- Reserve requirement
  - Funds that a financial institution must retain "in the vault" to back customers' deposits
- Discount rate
  - Charged by the Fed for loans it makes to banks to meet temporary shortages in required reserves

Recent Legislation in the U.S. Banking Industry

- ✓ Depository Institutions Deregulatory and Monetary Control Act (DIDMCA) of 1980
- ✓ Reigle-Neal Interstate Banking and Branching Efficiency Act of 1994
- ✓ Gramm-Leach-Bliley Act of 1999
- ✓ Emergency Economic Stabilization Act of 2008
- ✓ Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
- ✓ Basil III Accord (2010)

U.S. Banking in the Future

- Deregulation
  - Intermediaries are more similar in operations
  - Number of intermediaries has decreased
- Large financial service corporations
- Overlapping of products available

International Banking

- Other countries have fewer financial institutions, but with more branches
- Foreign banks are allowed to engage in non-banking business activities
- Most of the world's largest banks are not U. S. banks
- Edge Act (1919)
- International Banking Facilities (IBFs)

Chapter Principles
Key Financial Intermediaries Concepts

- What is a financial intermediary? Why are there so many different types?
  - An organization that takes "deposits" and uses the money to generate returns
  - Individuals/businesses have differing needs that require different services and products
- What functions do financial intermediaries perform?
  - Primary function is to facilitate the transfer of funds from savers to borrows

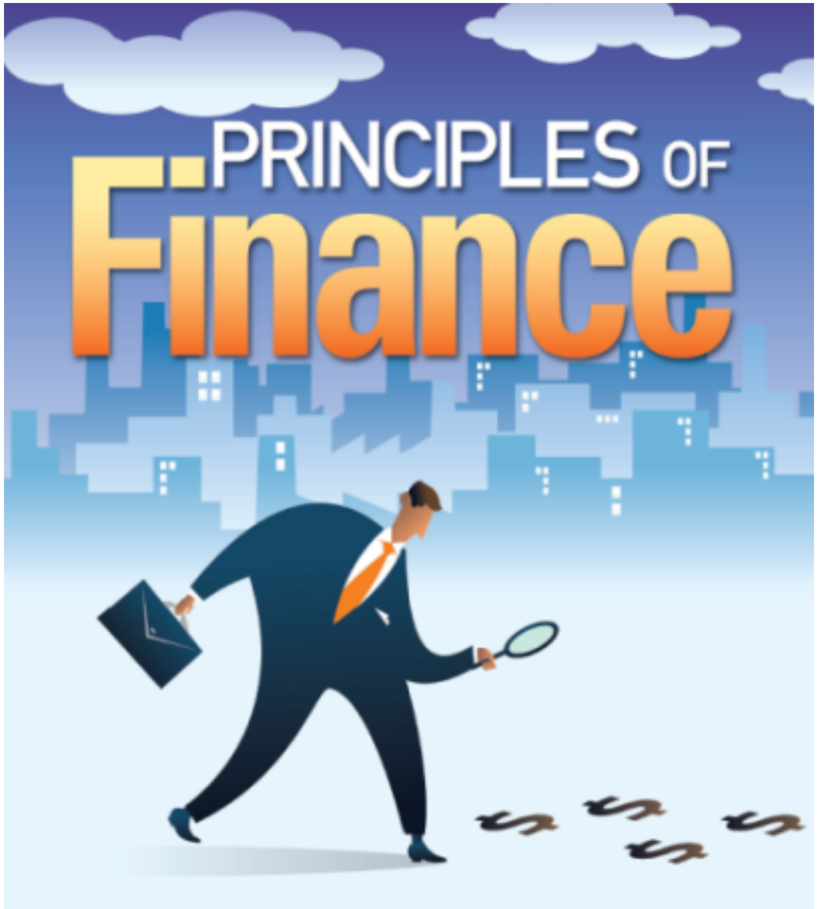
Chapter Principles
Key Financial Intermediaries Concepts

- What is a fractional reserve system?
  - Financial internediaries do not have to retain 100 percent of the funds that customers deposit
- What are the major characteristics of the U.S. banking system?
  - Based on the fractional reserve system
  - A dual banking system—banks are chartered either at the state level or the federal level

Chapter Principles
Key Financial Intermediaries Concepts

- What is the function of the Federal Reserve?
  - To direct the monetary policy of the United States
  - Manage the supply of money by buying and selling government securities
  - Manage existing reserve requirements of financial institutions
- How do banks in the United States differ from foreign banks?
  - In the U.S., there are more banks that are smaller in size and offer fewer services than in most foreign countries

End of Chapter 4



Financial Intermediaries and the Banking System