General Principles of Bank Management

MBMM Lecture 5.2.

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Outline

1. What Does a Bank Manager Do?
   - Liquidity Management
   - Asset Management
   - Liability Management
   - Capital Adequacy Management

What Does a Bank Manager Do?

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- Having low risk of default on the bank's assets (**Asset Management**)
- Acquiring funds at low cost (**Liability Management**)
- Managing the bank own capital (**Capital Adequacy Management**)

Liquidity Management

What happens in the bank when depositors start to withdraw money?

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Assets		Liabilities	
Reserves	\$20 million	Deposits	\$100 million
Loans	\$80 million	Bank capital	\$ 10 million
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If reserves are enough, deposit withdrawals cannot change much within the bank.

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If reserves are NOT enough, the bank has several options:

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   - not renewing the contract for loan
   - sell the loan to another financial institution

Liquidity Management

Consequences of insufficient reserves

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Excess reserves are an insurance for the bank

Asset Management

How to get the most of the bank assets with the least risk?

1. Borrow to firms and people with low risk of default
2. Try to set a competitive interest rate on loans
3. Purchase securities with low risk and high return (?)
4. Diversify
5. Hold luquid securities to meet reserve requirements easily

Liability Management

How to make the most out of the bank liabilities?

1. Borrow to other banks at the federal funds market
2. Issue new instruments: CoD
3. Invest the newly aquired funds using asset management

Capital Adequacy Management

Why a bank banager needs to manage the bank's capital?

1. Because the regulators say so (Capital Adequacy Ratios)
2. Because it affects the owners' return on investment
3. Because having enough capital prevents going out of business

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Capital Adequacy Management

Preventing Failure

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If own capital goes negative, the bank has to go bankrupt.

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Return on Assets (ROA)

$$ROA = \frac{\text{Profit after tax}}{\text{Assets}}$$

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Define **Equity Multiplier (EM)** $= \frac{\text{Assets}}{\text{Equity capital}}$. Therefore:

How do the bank owners make money?

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Who loves the bank manager more? Why?

High level of capital is, *ceteris paribus*, bad for the owners.

Banks desire to hold less capital to satisfy the owners (Why owners are happier when the bank has less capital? Can you show it using formulas and data from 2 different balance sheets?).

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Therefore, the regulators step in and set the **capital requirements: BASEL II agreement**.