

General Principles of Bank Management

ECO 420 Lecture 5.2.

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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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What Does a Bank Manager Do?

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- Having enough cash to pay depositors (**Liquidity Management**)
- 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?

Liquidity Management

What happens in the bank when depositors start to withdraw money? Let the initial balance sheet be:

Assets		Liabilities	
Reserves	\$20 million	Deposits	\$100 million
Loans	\$80 million	Bank capital	\$ 10 million
Securities	\$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:

Liquidity Management

Consequences of insufficient reserves

What can the bank do when it does not have enough reserves?

Liquidity Management

Consequences of insufficient reserves

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Liquidity Management

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Liquidity Management

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- ④ Reduce loans
 - not renewing the contract for loan
 - sell the loan to another financial institution

Liquidity Management

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Excess reserves are an insurance for the bank

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 liquid securities to meet reserve requirements easily

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 acquired funds using asset management

Why a bank manager 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

Capital Adequacy Management

Preventing Failure

Let's have two banks: High Capital and Low Capital.

Capital Adequacy Management

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Capital Adequacy Management

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Capital Adequacy Management

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

Capital Adequacy Management

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Capital Adequacy Management

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

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

Capital Adequacy Management

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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.