FINANCIAL MARKETS AND INSTITUTIONS

BANKS

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DEAMS
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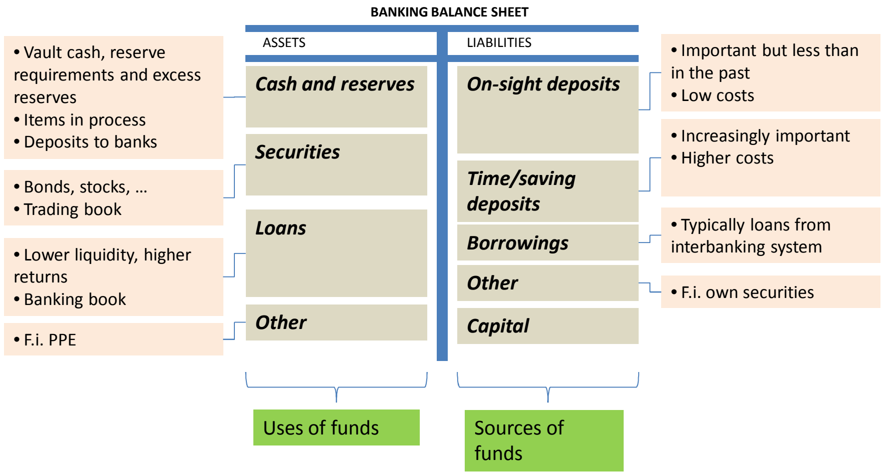
AGENDA

- Financial structure of banks
- Main banking management areas
- Banking performance
- Structure of the banking industry

FINANCIAL STRUCTURE OF BANKS

- Typically, a bank has the following financial structure

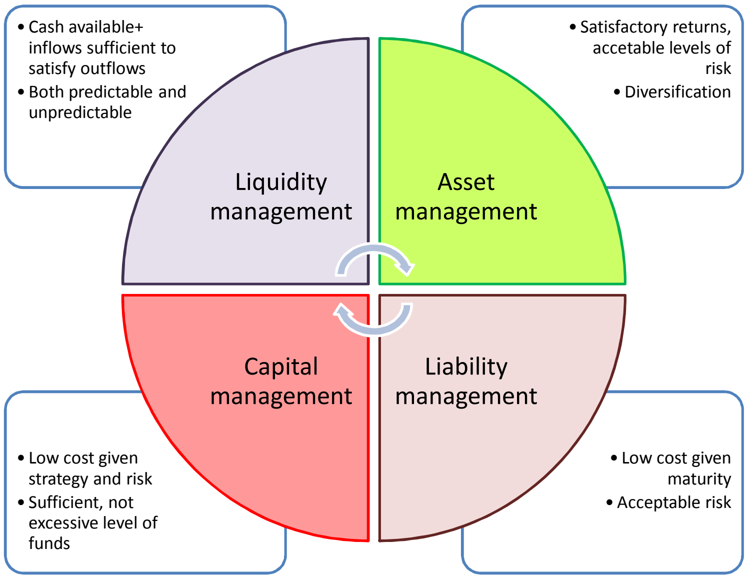


FINANCIAL STRUCTURE OF BANKS

Banking operations move around **asset transformation**:

- Selling liabilities with features desirable by lenders
- Buying assets with features desirable by borrowers
- Profitable if liabilities are cheap compared to returns on assets (rationale of intermediation)
- But risky if short-term liabilities question bank's soundness compared with less liquid, longer-termed assets (bank runs)
- Transforming both **liquidity** and **credit** risks

BANK MANAGEMENT



BANK MANAGEMENT

<u>Liquidity management</u>

- Excess reserves reduce liquidity risks stemming from deposits, but reduce banks' profitability
- Lack of reserves is costly, since it requires more borrowing, selling of assets, discount lending, not renewing due loans

<u>Asset management</u>

- At the same time provide profitability, safety and liquidity
- Managerial options: asset selection, borrowers' scrutiny, diversification, planning

Bank management

Liability management

- Historically the starting point of bank's operations
- Now activities are more asset-driven
- Management focuses on assets and liabilities together (ALM)

Capital management

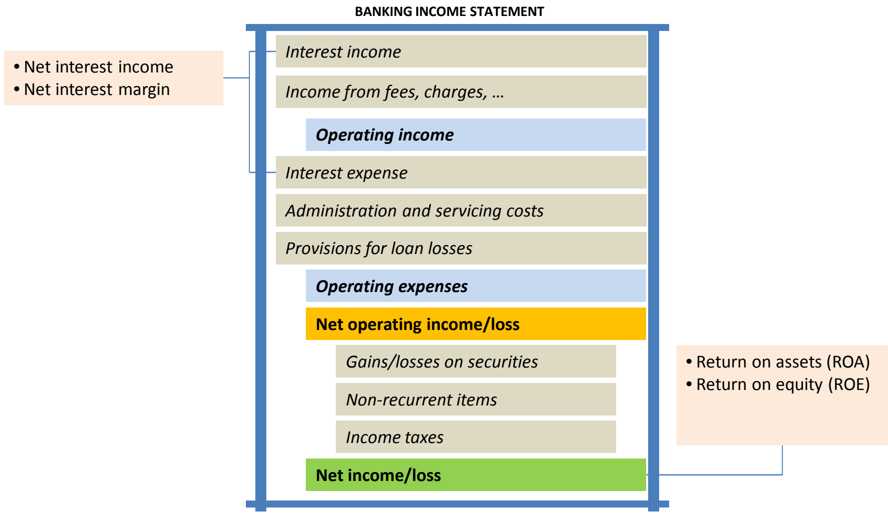
- Financial strength reduces likelihood of failures
- But more capital is costly and can produce lower profitability results
- Restraints come from supervisors, rating agencies and markets
- "Capital crunch" anticipated today's credit crunch

Bank management

- Banks also provide products and services that do not influence balance sheets directly: **off-balance sheet** activities
- Main examples:
  - Servicing loan sales
  - Servicing securities' issues
  - Accessing markets on behalf of customers (Forex, stocks, …)
  - Issuing guarantees on debt of customers or loan commitments
  - Trading in derivatives and currencies
- Off-balance sheet activities provide significant **profitability** but at the cost of material increases in **risk**-taking

BANK PERFORMANCE

- As a whole, can be derived from income statements



BANK INDUSTRY

Historical and current major issues:

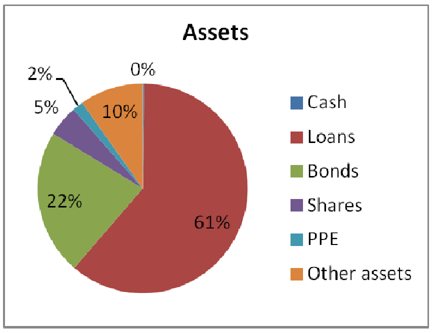
- heaviness of **regulation** on banks and related tools
- separation between **lending** and **trading** in securities
- separation between **borrowers** and **ownership** of banks

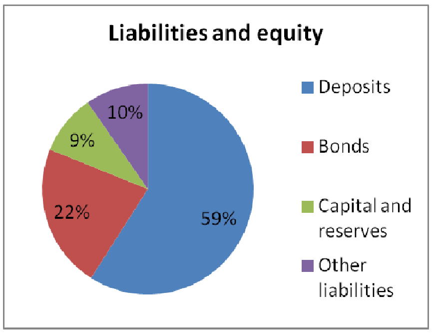
However:

- heavy regulation stimulates innovation to arbitrage across financial sectors since it promotes profitability through risk-taking (f.i. shadow banking)
- separations can be circumvented or avoided (f.i. country borders, securitisation, …)
- innovation is faster than rule-based regulation (f.i. Web)
- regulation has costs, can lower efficiency and competition (f.i. interest rate restrictions)

EXAMPLES

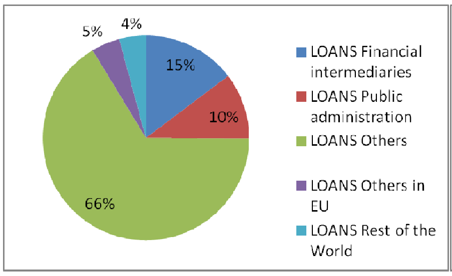
1. The following is the balance sheet of Italian banks as of 31 March 2013, totaling 4,213 billion €. Comments?

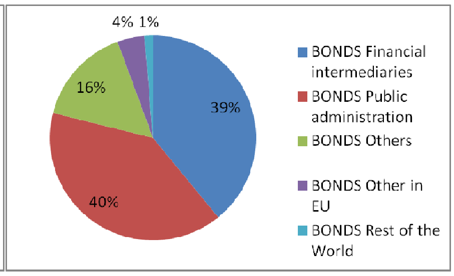


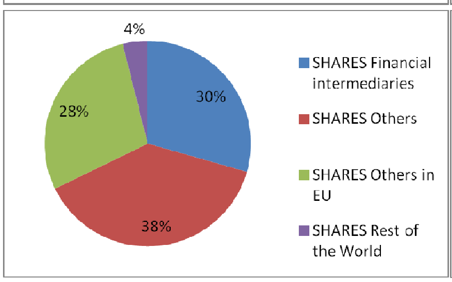


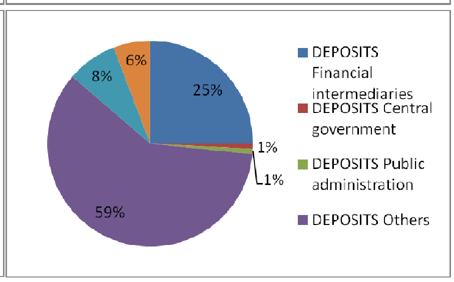
EXAMPLES

2. As in #1, detailing main assets and liabilities. Comments?









EXAMPLES

3. As before, detailing loans totaling 2,650 bln €. Comments?

Banks	ITA	347,293	13.09%
	EURO	80,867	3.05%
	ROW	90,129	3.40%
Monetary institutions	ITA	30,382	1.15%
	EURO	80,762	3.04%
Financial intermediaries	ITA	237,384	8.95%
	EURO	23,734	0.89%
Insurers and pension funds	ITA	4,819	0.18%
	EURO	161	0.01%
Government	ITA	184,846	6.97%
	EURO	605	0.02%
Public administrations	ITA	82,833	3.12%
Non financial companies	ITA	855,244	32.24%
	EURO	9,455	0.36%
Consumer families	ITA	499,635	18.83%
Production families	ITA	96,667	3.64%
No profit organisations	ITA	10,220	0.39%
Other	EURO	436	0.02%
	ROW	17,681	0.67%

EXAMPLES

4. The following is the Italian banking income statement as of Dec. 2012 (mln €). Comments?

Interest income			82,141
	-CB	*135*	
	-Banks	*5,048*	
	-Loans	*58,736*	
	-Bonds	*13,789*	
	-Other	*4,433*	
Interest expense			-47,002
	-CB	*-1,931*	
	-Banks	*-5,882*	
	-Loans	*-10,848*	
	-Bonds	*-24,106*	
	-Other	*-4,235*	
Hedging derivatives			1,953
Interest margin			**37,092**
Revenues from trading			5,498
Revenues from servicing			22,084
Other revenues			9,890
Intermediation margin			**74,564**
Salaries			-24,459
Other operational costs			-22,450
Operating result			**27,655**
Impairment on loans			-24,195
Other impairments			-6,057
Other income and expense			-2,233
EBT			**-4,830**
Income taxes			2,349
Net income			**-2,480**