

Commercial Banks and Investment Banks

1. Commercial banks and investment banks are two important institutions operating in financial markets. Construct a table with two columns headed: **Commercial Bank** and **Investment Bank** respectively.

Put the following functions under the correct heading but remember that some of these functions may be carried out by both commercial and investment banks:

Advise on new share issues

Provide loans and overdrafts to small businesses

Accept deposits from households

Provide an efficient means of payment

Provide help with mergers and takeovers

Underwrite new share issues

Trade in bonds and equities on behalf of clients

Buying and selling foreign exchange

Trade shares, corporate bonds and government bonds on their own behalf

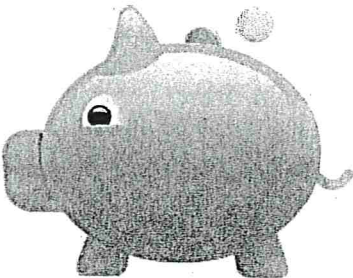
Provide mortgages to finance house-purchase

Arrange loans to help finance large infrastructure projects

Participate in commodity trading

Give advice to individuals and small businesses about financial matters

Manage large investment portfolios on behalf of clients, e.g. pension funds



2. Commercial banks are in business to make a profit but they must also remain sufficiently liquid.
 - a. Why do commercial banks need to make a profit? Give **more than one** reason.
 - b. Briefly describe how commercial banks make a profit.
 - c. What is meant by liquidity?
 - d. Commercial banks borrow short term and lend long term.
 - i. Describe what this means.
 - ii. Explain why it creates a problem for the banks.
 - e. Explain why there is a potential conflict, or trade-off, between profitability and liquidity
 - f. How do the banks attempt to overcome this conflict?



3. The way in which a commercial bank attempts to deal with the trade-off between profitability and liquidity is reflected in the structure of its balance sheet.

a. Copy out and complete the following by filling in the gaps:

A b _ l _ n _ c _ e s _ e _ e _ t always balances because total ass _ _ _ s **MUST** equal total lia _ _ l _ i _ t _ _ _ s. Total liabilities include the _ _ p _ i _ t _ _ l of the business, also known as sh _ _ r _ e _ h _ o _ _ l _ d _ e _ r _ s' fun _ _ _ s. The ca _ _ p _ i _ t _ a _ l and other li _ _ b _ i _ l _ i _ t _ i _ e _ s represent what the business o _ _ w _ e _ s to other eco _ _ n _ o _ m _ i _ c a _ _ g _ e _ n _ t _ s but it also shows w _ _ h _ e _ r _ e the bu _ _ s _ n _ e _ s s gets its m _ _ n _ y from, i.e. its sou _ _ _ _ _ e of f _ _ u _ n _ d _ s. The ass _ _ _ _ s can be viewed as what the business o _ _ w _ n _ s but they also rep _ _ r _ e _ s _ e _ n _ t what the b _ _ _ _ n _ e _ s _ s does with the _ _ _ _ n _ d _ s that have b _ _ _ _ n made av _ _ _ _ l _ a _ b _ l _ e to it.

b. Place the following assets of a commercial bank in order of decreasing liquidity, i.e. place the most liquid assets at the top of the list and the least liquid at the bottom:

Advances, Balances at the Bank of England, Fixed assets (e.g. buildings), Money lent at call to other banks, Holdings of government bonds, Notes and coins, Treasury bills, Commercial bills, holdings of corporate bonds

- c. Share capital and reserves represent the capital of a bank. Explain how a commercial bank is able to increase its capital.
- d. What represents the largest source of funds to a typical commercial bank?
- e. What other sources of funds are available to a typical commercial bank?
- f. Explain why each of the following represent a liability for a commercial bank:
- Share capital
 - Customers' deposits



Think!!!!

4. Commercial banks and investment banks are examples of financial intermediaries.
 - a. Explain what is meant by the term *financial intermediary*.
 - b. Name two other examples of financial intermediaries operating in the UK.

5. Write a paragraph explaining the role that commercial banks play in the functioning of the UK economy.

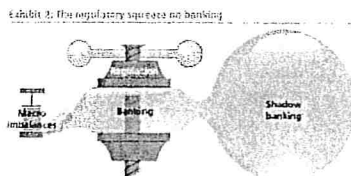
Extension activities – stretch and challenge

1. Find out about the role of investment banks in each of the following areas and write a brief description of their activities:
 - a. New share issues and the underwriting of new share issues
 - b. Mergers and acquisitions
 - c. Market activities, e.g. acting as brokers, market making and proprietary trading
 - d. Asset management

2. Although its growth was temporarily checked by the 2007/09 financial crisis, there has been a substantial growth in *shadow banking* during the 21st century.



- a. Explain briefly what is meant by the *shadow banking sector* (SBS).
- b. What are the benefits to economies of the growth of shadow banking?
- c. Why are central banks concerned about the growth of shadow banking?
- d. Why might the increase in the regulations that are being imposed on banks in the wake of the financial crisis stimulate the growth of the SBS?

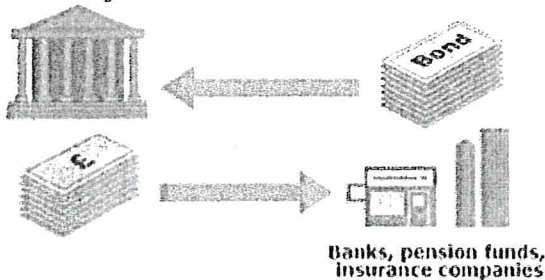


Activities

Task 1

A £100 bond has a current market price of £90 and the coupon payable on the bond is £4.50 per annum. Calculate the current yield.

Bank of England



Task 2

A £100 bond has a current market price of £120 and the coupon payable on the bond is £9 per annum. Calculate the current yield.

Task 3 Complete the following by filling in the gaps:

When the g _ v _ _ _ _ _ t first issues a b _ _ d, it must offer a rate of return that is s _ _ _ l _ r to that which can be earned on other risk-free as _ _ _ s. A rise in the m _ _ _ _ _ rate of interest will lead to a fall in the market _ _ _ _ _ of government bonds so that the _ _ _ _ _ d is once again similar to that which can be earned on other assets. For example, if the current market rate of interest r _ _ _ s from 5% to 10%, the price of a £100 bond paying a c _ _ _ _ n of £5 per annum will have to fall to around £50 to make it attractive to potential buyers (investors). If the market price remained at £100, n _ b _ _ dy would want to b _ _ y the bond.

Similarly, if the m _ _ k _ _ t rate of interest fell from 5% to 2.5%, investors would be clamouring to buy a bond that p _ _ d £5 each year if the market price was £100. As a result, the price of the bond would be bid up until the yield had fallen to around 2.5%, i.e. the p _ _ _ e of the b _ _ _ would r _ _ e to approximately £ _ _ _ .

Task 4

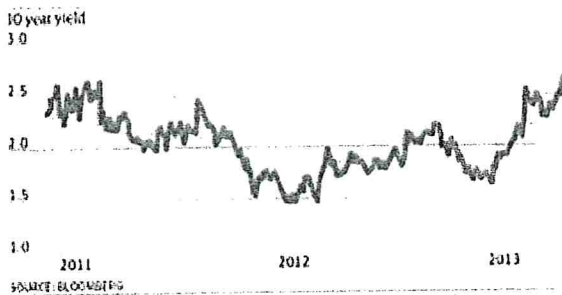
A £100 bond was issued with a coupon of £6 per annum and 50 years to maturity. At the time, the interest paid on similar assets was around 6%. Two years later, the market rate of interest had fallen to 4%. What is likely to have happened to the market price of the bond?



Task 5

A £100 bond was issued with a coupon of £3 per annum and 50 years to maturity. At the time, the interest paid on similar assets was around 3%. Four years later, the market rate of interest had risen to 7.5%. What is likely to have happened to the market price of the bond?

UK Government Bonds



Stretch and challenge

Explain why the price of government bond that only has 2 years until maturity will not change very much when there is a change in the market rate of interest.

An existing government bond with a face value of £100 has 2 years until maturity. The bond has a coupon of £2 per annum. Estimate the current market price of the bond if the current market rate of interest on assets with a similar risk is 6%.