FINANCIAL INTERMEDIARIES

We have seen why financial intermediaries play such an important role in the economy. Now we look at the principal financial intermediaries and how they perform the intermediation function. They fall into three categories: depository institutions (banks), contractual savings institutions, and investment intermediaries. Table 1 provides a guide to the discussion of the financial intermediaries that fit into these three categories by describing their primary liabilities (sources of funds) and assets (uses of funds). The relative size of these intermediaries in the United States is indicated in Table 2, which lists the amount of their assets at the end of 1970, 1980, 1990, and 2001.

Depository Institutions

Depository institutions (which for simplicity we refer to as *banks* throughout this text) are financial intermediaries that accept deposits from individuals and institutions and make loans. These institutions include commercial banks and the so-called **thrift institutions (thrifts):** savings and loan associations, mutual savings banks, and credit unions.

Commercial Banks These financial intermediaries raise funds primarily by issuing checkable deposits (deposits on which checks can be written), savings deposits (deposits that are payable on demand but do not allow their owner to write checks), and time deposits (deposits with fixed terms to maturity). They then use these funds to make commercial, consumer, and mortgage loans and to buy U.S. government securities and municipal bonds. There are approximately 8100 commercial banks in the United States, and as a group, they are the largest financial intermediary and have the most diversified portfolios (collections) of assets.

TABLE 1 Primary Assets and Liabilities of Financial Intermediaries

Type of Intermediary	Primary Liabilities (Sources of Funds)	Primary Assets (Uses of Funds)
Depository Institutions (Banks)		
Commercial banks	Deposits	Business and consumer loans, mortgages, U.S. government securities and municipal bonds
Savings and loan associations	Deposits	Mortgages
Mutual savings banks	Deposits	Mortgages
Credit unions	Deposits	Consumer loans
Contractual Savings Institutions		
Life insurance companies	Premiums from policies	Corporate bonds and mortgages
Fire and casualty insurance companies	Premiums from policies	Municipal bonds, corporate bonds and stock, U.S. government securities
Pension funds, government retirement funds	Employer and employee contributions	Corporate bonds and stock
Investment Intermediaries		
Finance companies	Commercial paper, stocks, bonds	Consumer and business loans
Mutual funds	Shares	Stocks, bonds
Money market mutual funds	Shares	Money market instruments

Source: Federal Reserve Flow of Funds Accounts.

How Banks Earn Profits

...b Site Suggestions: ...p://www.federal ...rve.gov/releases ...ents (H.8) data on ...ts and liabilities of ...mmercial banks.

We begin our study of the business of banking by identifying a bank's sources and uses of funds, as summarized on its balance sheet. A **balance sheet** is simply a statement showing an individual's or firm's financial position at a particular point in time. It lists the uses of acquired funds, *assets*; the source of acquired funds, *liabilities*; and the difference between the two, *net worth*. The bank's net worth includes accumulated profits from doing business with savers and borrowers. Table 13.1 summarizes the consolidated balance sheet of all U.S. banks. By examining how banks attract funds and the loans they make with those funds, we can determine how a bank earns profits and maintains its role as a key intermediary in the financial system.

Bank Liabilities

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Bank liabilities are the funds the bank acquires from savers. The bank uses the funds to make investments or loans to borrowers. To obtain funds, banks offer savers a range of deposit accounts that provide depositors with services (such as paying by check) or incentives (interest payments) that encourage savers to keep their funds on deposit at the bank. These accounts include checkable deposits and nontransaction deposits. In addition to these sources of funds, banks often borrow in money and capital markets. Checkable deposits, nontransaction deposits, and borrowings are liabilities for the bank.

Checkable deposits. Banks offer savers **checkable deposits**, accounts that grant a depositor the right to write checks to individuals, businesses, or the government. These accounts include non-interest-bearing demand deposits, interest-bearing negotiable order of withdrawal (NOW) accounts, and super-NOW accounts. A NOW account is

TABLE 13.1 **Balance Sheet of U.S. Commercial Banks, 2006†**

Assets (uses of funds)		Liabilities (sources of funds) and net worth	
Reserves; Cash items in process of collection; Deposits at other banks	2.9%	Checkable deposits	8.0%
		Nontransaction deposits	
		Savings deposits and time deposits (CDs)	44.1
Securities	21.8	Large, negotiable time deposits (CDs)	11.6
U.S. government and agency	13.6	Borrowings (from the Federal Reserve, in the federal funds market, from subsidiaries and affiliates, and through repurchase agreements)	20.5
State and local government and other securities	8.2		
Loans	66.1		
Commercial and industrial	11.5	Miscellaneous liabilities	5.3
Mortgage	37.0	Equity capital (net worth)	10.5
Consumer	8.7		
Interbank	2.7		
Other loans	6.2		
Miscellaneous assets	9.2		

†Figures are expressed as a percentage of total assets for all domestically chartered commercial banking institutions in the United States as of August 30, 2006.

Source: Federal Reserve Statistical Release H.8, http://www.federalreserve.gov/releases/h8/Current/, September 8, 2006.

Exhibit 4–3 **Bank Report of Condition (Balance Sheet): Assets, Liabilities, and Capital of Insured Commercial Banks in the United States** ($ Billions, Year-End Figures)

	1980		1990		1997	
	Billions of Dollars	**Percent of Total Operating Income**	**Billions of Dollars**	**Percent of Total Operating Income**	**Billions of Dollars**	**Percent of Total Operating Income**
Assets:						
Cash and deposits due from banks	$ 331.9	17.9%	$ 318.0	9.4%	$ 355.1	7.1%
Investment securities:						
U.S. Treasury securities	104.5	5.6	150.8	4.4	154.6	3.1
Federal agency securities	59.1	3.2	275.6	8.2	505.9	10.1
State and local govt. securities	146.3	7.9	83.5	2.5	76.9	1.5
Corporate bonds	13.4	0.7	85.9	2.5	57.2	1.1
Corporate stock	1.8	0.1	8.8	0.3	25.7	0.5
Totals	$ 325.0	17.5%	$ 604.6	17.8%	$ 820.3	16.4%
Total loans and leases, gross	1,016.5	54.8	2,110.2	62.3	2,975.2	59.3
Real estate loans	269.1	14.5	829.8	24.5	1,215.7	24.2
Commercial and industrial loans	391.0	21.1	615.0	18.1	795.9	15.9
Loans to individuals	187.4	10.1	403.5	11.9	561.4	11.2
Agricultural loans	32.3	3.2	33.3	1.0	44.9	8.9
Loans to depository institutions	81.2	8.1	51.2	1.5	85.1	1.7
All other loans and leases	55.5	5.5	177.4	5.2	272.2	5.4
Less: Unearned income	−21.0	−2.1	−13.7	−0.4	−4.5	−0.1
Allowance for loan and lease losses	−10.1	−0.5	−55.5	−1.6	−54.7	−1.1
Net loans and leases	1,006.4	54.2	2,054.6	60.6	2,916.0	58.1
Bank premises and equipment	26.7	1.4	51.4	1.5	67.2	1.3
Other real estate owned	2.2	0.1	21.6	0.6	4.5	0.1
Intangible assets	NA	NA	10.6	0.3	61.7	1.2
All other assets	163.4	8.8	328.5	9.7	476.8	9.5
Total assets	$1,855.7	100.0%	$3,389.5	100.0%	$5,014.9	100.0%
Liabilities:						
Total deposits	$1,481.2	79.8%	$2,650.1	78.2%	3,421.7	6.8
Demand deposits	431.5	23.3	463.9	13.7	591.3	11.8
Savings deposits	200.9	10.8	798.1	23.5	1,173.8	23.4
Time deposits	554.7	29.9	1,094.7	32.3	1,130.4	22.5
Other deposits	294.1	15.8	293.4	8.7	526.2	10.5
Borrowings in the money market	177.7	9.6	385.3	11.4	637.5	12.7
Subordinated capital notes and debentures	6.5	0.4	23.9	0.7	62.0	1.2
Other liabilities	82.7	4.5	111.5	3.3	475.8	9.5
Total liabilities	$1,748.1	94.2%	$3,170.8	93.5%	$4,597.0	91.7%
Equity capital:						
Preferred stock	$ 0.1	0.0*	$ 1.7	0.1	2.4	0.1
Common stock	21.7	1.2	30.9	0.9	34.4	0.7
Surplus	37.8	2.0	92.4	2.7	190.7	3.8
Undivided profits	48.0	2.6	93.7	2.8	191.8	3.8
Total equity capital	107.6	5.8	218.6	6.4	417.9	8.3
Total liabilities and capital	$1,855.7	100.0%	$3,389.5	100.0%	$5,014.9	100.0%

*Less than $50 million.

Source: Federal Deposit Insurance Corporation, *Historical Statistics on Banking*, 1934–1992, and *Statistics on Banking*, 1997.

Exhibit 4–6 **Bank Report of Income (Earnings and Expense Statement): Income and Expenses of Insured Commercial Banks in the United States, 1980,1990, and 1997**

	1980		1990		1997	
	Billions of Dollars	**Percent of Total Operating Income**	**Billions of Dollars**	**Percent of Total Operating Income**	**Billions of Dollars**	**Percent of Total Operating Income**
Total interest income:	$176.4	92.5%	$320.5	85.4%	$339.6	76.5%
Interest and fees on loans	127.0	66.7	234.4	62.4	249.8	56.2
Lease income	1.4	0.7	4.4	1.2	7.0	1.6
Income from investment securities	23.1	12.1	51.1	13.6	52.8	11.9
Trading account income	NA	NA	5.4	1.4	10.1	2.3
Income from federal funds loans and security RPs	8.8	4.6	12.5	3.3	13.6	3.1
Other interest income	16.3	8.5	12.7	3.4	6.4	1.4
Total interest expense:	$120.1	63.0%	$205.0	54.6%	$165.0	37.2%
Interest on deposits	34.9	18.3	161.5	43.0	117.3	26.4
Interest on federal funds and security RPs	16.8	8.8	22.7	6.0	20.6	4.6
Interest on subordinated capital notes and debentures	0.5	0.3	1.8	0.5	4.0	0.9
Interest on other borrowed funds	4.4	2.3	18.9	5.0	23.1	5.2
Net interest income	$ 56.3	29.5%	$715.5	30.8%	$174.6	39.3%
Total noninterest income:	14.3	7.5	54.9	14.6	104.5	23.5
Service charges on deposits	3.2	1.7	11.4	3.0	18.5	4.2
Other noninterest income	11.2	5.9	43.4	11.6	86.0	19.4
Total noninterest expense:	46.7	24.5	115.8	30.8	170.0	38.3
Employee salary and benefits	24.7	13.0	51.8	13.8	71.8	16.2
Occupancy expenses	7.4	3.9	17.4	4.6	22.0	5.0
All other noninterest expenses	14.6	7.7	46.6	12.4	76.2	17.2
Net noninterest income	−32.4	−17.0	−60.9	−16.2	−65.5	−14.7
Provision for loan and lease losses	4.5	2.4	−32.1	8.6	19.8	4.5
Pretax net operating income	19.5	10.2	22.6	6.0	89.3	20.1
Securities gains (or losses)	(0.9)	(0.5)	0.5	0.1	1.8	0.4
Applicable income taxes	4.7	2.5	7.7	2.1	31.9	7.2
Net extraordinary items	0.0*	0.0**	0.6	0.2	0.2	0.1
Net income after taxes	$ 14.0	7.3%	$ 16.0	4.3%	$ 59.2	13.3%

*Less than $50 million.
**Less than 0.05 percent.
Source: Federal Deposit Insurance Corporation.

technical and people skills and the capacity to learn new methods in a dynamic financial marketplace.

MONEY CREATION AND DESTRUCTION BY BANKS

Commercial banks differ from many other financial institutions in one critical respect: *Banks have the power to create money in the form of new checkable deposits, credit card lines, debit cards, and other immediately spendable funds.* The banking system creates and destroys billions of dollars in money each year at the stroke of a pen or merely by posting

Who is interested in bank performance