Lecture 14

Banking and Finance
Banking & Finance

I. Banks

II. Securities

III. Geography
I. BANKS

A. •Banks & Money
B. Banks & Credit
C. Bank Services
D. Bank Regulation
Banks & the circulation of money

- Money storage
  - Accounts (current balance)
    - ‘Savings’ (what’s left)
- Money inflow
  - Deposits (income, revenues)
- Money outflow
  - Spending & purchases
- Interbank flows
  - Settling accounts

- Banks as utilities
  - Like water & electricity
  - ATMs = faucets & plugs
Commercial banks

} Basic banks
  ▪ Unit & branch forms

} Inter-bank system
  ▪ Settling accounts
  ▪ Check clearinghouses
  ▪ Federal Reserve Bank
What is money?

Money is not a good nor a service
  - Money = value

Functions of money
  - Means of exchange
  - Measure of value
  - Store of value
Types of Money

- Metallic money
  - Gold & silver
- Government money
  - Coinage
  - Greenbacks (paper)
- Bank money
  - Checks
  - Credit cards
  - Debit cards

*Which leads us to credit...*
I. BANKS

A. Banks & Money
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Lending

Credit = Loans

Lending
- Lender
  - Has money, makes ‘profit’
  - (= interest)
- Borrower
  - gets money (for a time), pays for it
  - (= interest)

Price of credit
- Rate of interest

"We have a cash flow problem too. Our problem is that your mortgage payments aren't flowing our way."
Bank Credit

- Business of banks is lending
  - Bank ‘assets’ = loans

- Banks are key lenders in economy
  - Business & consumer loans

- Bank loans = new money
  - Checks
  - Debit cards
  - Credit cards
Consumer lending

- Bank credit cards
  - VISA, Mastercard, Diners Club, etc.

- Bank consumer loans
  - For major products
    - Car loans
    - Mortgages
Business lending

} Banks as ‘financiers’
  ▪ Loans to business

} Credit for investment = new capital
  ▪ Essential to growth

} Long-term loans
  ▪ Capital investment

} Fictitious capital
  ▪ Credit capital
  ▪ Speculation & capitalist investment

} Short-term loans
  ▪ Commercial paper
  ▪ ‘Bridging loans’
Inter-bank credit

- Settling accounts
  - Time delay

- Bridging loans
  - Inter-bank market
    - LIBOR rate
  - Almost froze, 2007 & 2008
I. BANKS

A. Banks & Money
B. Banks & Credit
C. Bank Services
D. Bank Regulation
Banking ‘products’

Money ≠ good or service

Commodifying banking
- Packaged services
- Fee for service

Marketing services
- Decline of traditional banker & personal service
Bank fees & profits

Bank resurgence in 1990s -- on our backs

Direct, and to the point - I like that in an advertising campaign, Jenkins
I. BANKS

A. Banks & Money
B. Banks & Credit
C. Bank Services
D. Bank Regulation
Basic oversight

} Charters
  - State Banks
  - National Banks

} Accounting
  - Reporting & auditing
    - Like all corporations

} Agencies
  - US Treasury
    - Comptroller of Currency (1863)
  - State Financial regulators
State & National Banks

Jacksonian System
- 19th century
- Regulation by states
- US the most decentralized

‘National’ bank system
- Circa 1880s
- Branch banking > 1900
- Bigger state-based banks
Federal Reserve system

} ‘The Fed’
- Central Bank
- Created 1913
  - After 1907 crisis

} Bank for banks
- Reserve requirement
- Lends to banks

} Regional Feds
- Bow to Jacksonians
- NY Fed the key bank
New Deal System

- 1930-33 bank collapse

New Deal
- FDIC – deposit insurance
  - Stopped bank runs
- Glass-Steagall firewall
  - Split commercial & investment banks (securities)
- Mortgages
  - S&Ls
  - FHA guarantees
  - FNMA
Neo-liberal system

Bank deregulation
- End interest & fee limits
- Interstate banking
- End firewall
- Expand secondary markets

Bank Concentration
- Number of banks halved > 1980
  - Worse > crisis of 2008
- 10 top banks dominate
  - from 30% to 50% of assets, 1997-2007
- ‘Too big to fail’?

Results
- Higher fees & bank profits
- Bank concentration
- Tighter link to securities/capital markets
International regulation

} There isn’t much…
  • Mostly by nation-states

} IMF
  • Not a Central Bank
  • Lender of last resort
  • Lends to governments

} Lowering the bar
  • Competition to unleash banks
    □ ‘the Big Bang’ & NY response

} Bank havens
  • Deregulation of offshoring
  • Terror & tightening
Monetary policy

- Manipulating money supply
- To stabilize economy

Money manipulations

- Fed
  - Reserve ratio
  - Discount rate
- Treasury
  - Buying & selling T-bills
Lecture 14: Banking & Finance

I. Banks

II. • Securities

III. Geography
II. SECURITIES

A. Securities & Capital
B. Capital Markets
C. Risk Capital
D. Triumph of Securities
Basic securities

 Stocks (equities)
  - Corporate
  - Claims on assets (ownership)
  - Claims on profits (dividends)
  - Types of shares

 Bonds
  - Corporate & government
  - Set life-span (maturity)
  - Face value & interest
  - One-time & continuous interest
New issues & old

} New securities
  - Raise capital for companies, governments

} Old securities
  - Continue to circulate (primary markets)
  - Yield (interest, dividends, etc) & capital gains
Securitized loans

} The trade in old loans
- Mortgages
- International loans
- (also insurance policies)

} Banks sell loans to investors
- Injects new capital into bank
  - Which can issue more loans
- Interest goes to new owner
- Trade in secondary markets
Bundled securities

{ Mutual Funds
  - Sets of stocks & bonds
    - Variety of ‘products’
  - Traded like regular stocks & bonds
    - In primary markets

} CDOs and all that
  - Rebundling securities
  - Tranches & pieces of securities
II. SECURITIES

A. Securities & Capital
B. •Capital Markets
C. Risk Capital
D. Triumph of Securities
Primary markets

} Stock Markets
  - Open floor
    - NYSE, LSE, Hong Kong
  - Fully computerized
    - NASDAQ first, now all

} Bond Markets
  - Handled by big commercial banks
  - Trading rooms & computer networks
Secondary markets

Secondary mortgage market

- Mortgage repackagers
  - FNMA, GNMA (~50%)
  - Investment Banks (~50%)
- Sold to investors
- Special markets
  - Bank trading rooms & computer networks

Derivatives markets

- Specialized institutions
  - CBOT, LIFFE, Euronext
- Trading floors & computer networks
Bankers & brokers

} Investment Banks
- Handle new issues (for corporations)
- Solomon Bros, JPMorgan, Goldman, Lehman Bros, etc.

} Brokerages
- Handle trades of existing securities
- Members of exchanges

} Mutual Funds
- Specialized firms
- E.g., Franklin-Templeton, Dodge & Cox, Vanguard, etc.
Capital markets’ strengths

} Gather savings -- with a return
  ▪ Dividends, interest, etc.
  ▪ Capital gains

} Raise capital
  ▪ With new issues

} Price regulation
  ▪ Measures worth of corporations
  ▪ Adjusts with changing fortunes
Capital markets’ weaknesses

} Generate little new capital
  ▪ Only new issues, like IPOs

} Parasitism
  ▪ Rich investors skim off dividends & interest

} Speculation
  ▪ Just a Casino?
II. SECURITIES

A. Securities & Capital
B. Capital Markets
C. (High) Risk Capital
D. Triumph of Securities
Derivatives

Contracts on securities
- Not assets
- Profits from price changes of assets

Types
- Futures, options, calls, etc.

Functions
- Speculation, hedging & arbitrage
Hedge funds

- Deal in derivatives
  - Play against the markets
  - About 1/3 of all derivative trades

- Risk management?
  - Mostly US investors, who are risk takers

- Unregulated
  - No one knows how big they really are
Private equity funds

} Specialized financiers
} Large risk-taking funds
} Buy & sell whole companies
Sovereign wealth funds

- National investment funds
  - Began in Persian Gulf
  - Now China, Russia, etc. etc.
Risk, right & speculation

‘Risk society’

- Language of risk comes into vogue
- ‘Risk’ takes moral bite out of greed
- Finance’s new function:
  - Eliminate risk

Greenspan sees no derivatives problem

WASHINGTON — Federal Reserve Chairman Alan Greenspan, taking issue with the warnings of billionaire investor Warren Buffett, said Thursday that the growing use of complex financial instruments known as derivatives does not pose a threat to the country’s financial system.

Greenspan said that financial market participants who purchased derivatives, including banks, had been able to spread their risks and that had helped to lessen the severity of the 2001 recession.

“Even the largest corporate defaults in history — Argentina — have not significantly impaired the capital of any major financial intermediary,” Greenspan said in remarks delivered by satellite to a banking conference in Chicago.

“The benefits of derivatives, in my judgment, have far exceeded their costs,” Greenspan said.

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In this year’s letter, Buffett contended that derivatives were “financial weapons of mass destruction” because they posed grave risks to the financial system.

Derivatives essentially are complex financial instruments designed to transfer risk from one party to another.
II. SECURITIES

A. Securities & Capital
B. Capital Markets
C. Risky Capital
D. •Triumph of Securities
Rise of Securities

} Origins (c. 1700-1800)
  ▪ Bank of England (1688)
  ▪ NYSE (1810)

} Railroad era (1850s-70s)
  ▪ RR & NYSE
  ▪ Mining & SF exchange
  ▪ Crisis of 1870s

} Corporate era (1900s-1920s)
  ▪ Rise of investment banks
    ▪ JP Morgan & mergers
  ▪ Regional exchanges

} Crisis of 1929
  ▪ Stock market collapse
  ▪ Severe blow to securities

} New Deal era (1930s)
  ▪ Reform of banks & securities
    ▪ FDIC – deposit insurance
    ▪ Bank Firewall (Glass-Steagall)
      ▪ between commercial & investment banks
    ▪ SEC – exchange regulation
    ▪ FHA – mortgage guarantees

} Postwar era (Golden Age)
  ▪ Securities contained
  ▪ Little rise in stocks
  ▪ Banking in command
New Financial Era > 1975

- Low-cost trading
  - Schwab et al.
  - Depersonalized & popularized
- Secondary markets
  - Esp. mortgages (GNMA).
  - End of S&Ls
- Derivatives
  - Invented in Chicago
  - Taken up in NY & London

[Image of a Time Magazine cover with a man smiling]
Neoliberal Finance

} Deregulation
- SEC weakened
- Commercial banks
  - Interest & fees
- End of firewall
- Derivatives
- No regulation of hedge funds (2004)

} Attempt to slow the train...
- Oxley-Sarbanes (2004?)
  - After crash of 2000
  - Accounting scandals
Explosion of finance

- Growth of financial sector
  - > 20% of US economy
  - K. Phillips, Mad Money

- Securities trading > bank lending
  - By 2003

- Derivatives market balloons
  - ~ $480 trillion in 2007
  - 15+ times its value in 2000.
  - 12 X size of world economy

- Equity & Sovereign funds
  - Trillions upon trillions
Banks & Securities

} Bank-Securities link
  ▪ Back with a vengeance

} Leverage
  ▪ Banks playing the markets
  ▪ Bank lending to play the markets

} We see the results today....
Lec. 14: Banking & Finance

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III. • Geography
III. Geography

A. • Banks

B. Securities

C. Capital Flows
Local Banking

- Unit Banks
  - recycle savings

- Branch banks
  - Spatial reach

- Big city banks
  - Headquarters

- Boutique banking
  - Niche banks in the age of the mammoths
Regional banking

} Banks & regional economies
  - SF & Pacific Coast

} Regional linkages
  - State-based banks
  - Correspondent banks
  - Lending pathways

} Regional bank rivalries
  - SF vs. LA, etc.
  - Osaka vs. Tokyo
  - Toronto vs. Montreal
National Banking

- National bank centers
  - New York, Tokyo, Bangkok, Paris, etc.
- Banking hierarchy & urban hierarchy

Bank of America today
Global Banking

Old British banking system of 19th century
- Interwar retreat (like trade)

(Re)Globalization of banking >1950
- Bretton Woods & Dollar system
- Eurodollars
- Global branch banking

Global Cities
- Big 3: New York, London, Tokyo
- Second tier: Singapore, Osaka, Frankfurt, Mumbai, etc.

Offshore Banking
- Outside national regulations
- Bahamas, Isle of Man, Cayman Islands, etc.
Offshore Banking

- Tax-havens for big money
  - Safe-havens for hot money
- 26% of world’s wealth
  - 30+% of US MNC net π
Regulation & bank geography

} Jacksonian era
  - Most geographically decentralized in the world

} Branch banking/Fed era
  - Growth of big state banks
  - New York emerges as global center

} Neoliberal era
  - Multi-state banks
  - Global banks
  - Off-shore banks
III. Geography

A. Banks

B. Securities

C. Capital Flows
Location of Capital Markets

In biggest cities
- New York on top
- Regional exchanges
  - SF, Chicago, Philly

‘Financial districts’
- Interaction of firms
- Specialized labor pools
- Auxiliary services
Global keystones

} London
- Currency trading
- Over-the-counter derivatives (LIFFE)
- Stocks (LSE)
- IPOs
- Holding companies

} New York
- Stocks (NYSE)
- Hedge Funds (Greenwich, CT)
- Investment Banks (oops -- all gone now!)
- Insurance (Hartford CT)
- Equity Funds
Competing Cities

- New York took top spot in WW2
- London regained primacy by end of 1960s
  - Eurodollar market and international currency exchange – less regulation than US.
- NY back on top by 1980s
  - High interest & Reagan draw in global funds, NYSE booms
  - London hurt by British decline, old-fashioned system of banking.
  - London insurance collapsed when Lloyd’s hit wall in 1980s
- London regained #1 after the ‘Big Bang’ (1986)
  - swept out the old bankers & brought in Americans and competition
- NY rebounded in 1990s with long stock boom
  - London Stock Exchange lost ground
- London bounced back in 2000s, particularly in derivatives (LIFFE)
  - Doing well with Euro trading, as old national centers fell back before the EURO
  - Spectacular growth in shipping, brokerage, accounting and legal
    - (2000 firms, 3/4 of largest in the world)
- London passed NYC in IPOs in 2002
- NYC hurt by Oxley-Sarbanes public disclosure --
  - which Private Equity Funds & Hedge Funds evade.
Global financial centers

} Hong Kong passed NY in IPOs in 2000s.

} Euronext Exchange
  - Paris, Amsterdam, Lisbon and Bruxelles.
  - Euronext bought LIFFE in 2002
  - Euronext and NYSE merged in 2006.

} Deutsche Börse AG
  - Frankfurt
  - Euronext rebuffed Deutsche Börse

} Zurich (Eurex) in derivatives
Other players

}  Chicago and derivatives
   ▪ Chicago Mercantile Exchange & Chicago Board of Trade
      □ Merged in 2006
   ▪ Eurex is Swiss-German competitor in derivatives
      □ world’s largest until Chicago merger
   ▪ London does over-the-counter derivatives
      □ LIFFE (futures, founded 1982)

}  San Francisco & innovation
   ▪ Branch banking
   ▪ Credit cards
   ▪ Discount brokerage
   ▪ E-trading
   ▪ NASDAQ growth
Geography of hedge funds

- Greenwich, CT.
  - London (Canary Wharf)
  - Cayman Islands

- Greenwich ahead because...
  - Near NYC financial center
  - NY investment bankers hive off new hedge funds
  - US investors are risk-takers
  - Evading Oxley-Sarbanes regulations
III. Geography

A. Banks

B. Securities

C. Capital Flows
Globalization of Capital

- Flows across borders
  - Bank deposits & loans
  - Securities (‘Portfolio’)
  - FDI

- Flows along major pathways
  - through global cities
Global Bank Flows
Global stock markets
Global currency markets

} Largest of all
  ▪ Trillions $ per DAY

} Hedging trade

} Speculation
  ▪ George Soros
Global FDI

- ‘Foreign direct investment’
  - Plant & equipment
- Industrial expansion
  - From core countries
  - Now more from NICs