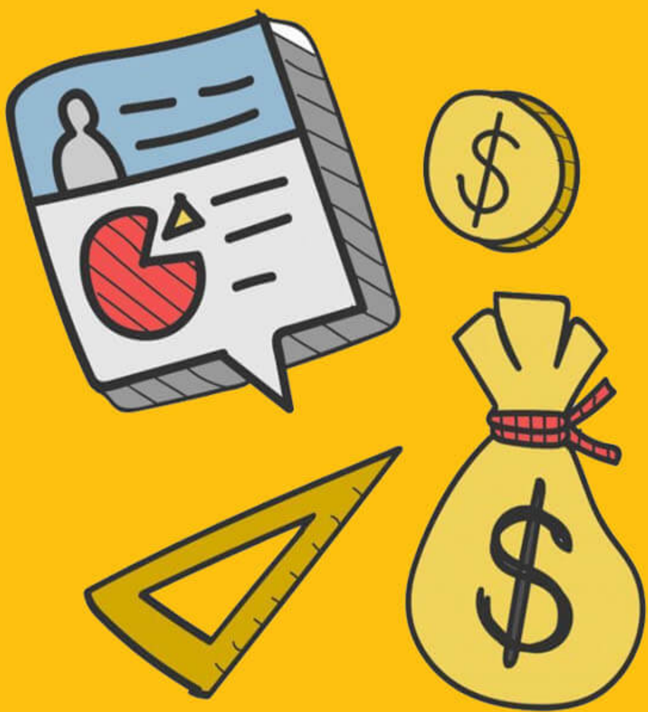
Commercial Banks and Investment Banks



AQA A Level Economics Revision Notes

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The difference between a commercial bank and an investment bank

A commercial bank manages deposits, cheques and savings accounts for individuals and firms. They can make loans using the money saved with them.
Investment banks facilitate the trade of stocks, bonds and other forms of investment. Government regulation is weaker in the investment bank industry, and this combined with their business model gives them a higher risk tolerance.

The main functions of a commercial bank

Accept deposits

Commercial banks accept deposits from the public, usually in the form of savings. Those on low incomes might save a part of their income for security, whilst firms see saving as convenient. Banks can meet the different needs of their depositors by providing different accounts. Depositors could use Demand Deposits, which allow deposits to be made or withdrawn immediately. This is useful for firms who need to make immediate payments. Alternatively, Fixed Deposits store money for a long time. They have higher rates of interest, since banks can use these deposits knowing they will not be withdrawn. Saving Deposits are done by those who withdrawn money often, but not necessarily immediately, and who are generally receiving an income. They have lower rates of interest than Fixed Deposits.

Provide loans

The main source of income for commercial banks is interest, which banks earn through providing loans. Banks **create credit** by using deposited funds as loans.

Some loans are secured against an asset, such as a house. This is to protect the bank's funds if the loan is not repaid.

Loans could be in the form of cash credit, on demand or only for the short term. Cash credit loans are based on bonds and approved securities. Banks enter agreements with customers so money can be withdrawn several times a year. Banks deposit money periodically into the accounts of the customer. Loans on demand are when the entire loan is paid into the account of the borrower. Therefore, the loan is charged with interest immediately. Short-term loans tend to be personal or for working capital and are usually against a security.

Overdraft

When a current account has no deposits, consumers can still borrow money from the bank in the form of an overdraft. These are at a high interest rate and the amount that can be borrowed is limited.

Investment of Funds

Surplus funds could be invested into securities such as Government bonds and treasury bills. These could earn a return for the bank.

Agency Functions

Banks represent their consumers. For example, they collect cheques and dividends, they pay and accept bills, such as through a direct debit, they deposit interest and income tax, buy and sell securities and arrange the transfer of money between places for consumers.

The structure of a commercial bank's balance sheet

Balance sheets show the value of a company's assets, liabilities and owner's equity during a period of time. It is usually at the end of a quarter or an annum.

A liability is something which must be paid. It is a claim on assets.

An asset is something that can be sold for value. The owner's equity is also called bank capital and it is what is left over when assets have been sold and liabilities have been paid.

Liabilities are used to buy assets, and income can be earned from these assets.

Liabilities are made up of share capital, deposits, borrowing and reserve funds. Assets are cash, securities and bills, loans and investments.

The objectives of a commercial bank and potential conflicts between these objectives

- **Liquidity**

The liquidity of assets is how easy it is to turn the assets into cash. Liabilities are payable on demand, so in order to be profitable banks must have cash and liquid assets. If liquidity is prioritised, profits will be low, so banks need a balance between the two objectives.

Assets in commercial banks are liquid to different extents. Cash is the most liquid asset, whilst deposits are the next most liquid. Loans and long term bonds are the least liquid assets in a commercial bank.

If banks can borrow easily and cheaply, they are likely to keep fewer liquid assets. The more expensive and difficult it is to get a loan, the more liquid assets are likely to be kept.

- **Profitability**

Banks need to earn profits to pay their depositors interest, wages and general expenses. Holding a lot of funds in cash means profitability is limited. However, liquidity and safety are generally prioritised over profitability, which is considered to be a supplementary for the bank's survival.

- **Security**

Banks face risks and uncertainties about how much cash they can get, and whether loans will be repaid or not. Banks therefore have to try and maintain the safety of their assets. A bank has to keep high proportions of their liabilities with itself and the central bank. However, following these principles means banks only hold their safest assets, so more credit cannot be created.

This means that banks profits are lower and the bank might lose customers. The bank needs a balance between the risk level and their profits. Too much risk could be harmful.