Examination Book

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SUBJECT Financial Markets & Institutions

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10/10

1 liquidity ratio ; $\frac{\text{loans}}{\text{deposits}}$, $\frac{\text{funds required (Assets - Liabilities)}}{\text{interest-sensitive assets}}$

false : This liquidity ratio is generally <u>larger</u> for small retail banks compared to big wholesale banks

Because large banks have more loan demand for large industrial & commerical firms relative to the deposits. Large banks therefore, acquire funds by issuing repo., CD's and by transaction in the euromoney market, and buying Federal funds. Also, large banks reduce the risks of interest exposure in the diversified portfolio. So the risk to these banks is smaller than that to smaller banks. Besides, these banks have the capacity to access to purchase funds well, selable Assets and liquidity assets mature shortly.

On the other hand, small retail banks deal with the regional customers with the limited deposits available there. They can get more deposits than loans to the regional firms & other customers. So they sell money in the Fed. Funds, euromoney, Treasury bills to earn the spread interest between deposits & these loan rates. Also, the risk of the regional banks is higher than large banks, because they have <u>lower</u> ability to save access to the purchased funds in international or national market, they just do through a correspondent bank. Small banks, for these reasons, have higher liquidity ratios as federal authorities & bank analysts look at the ratios of the bank compared with other similar retail banks.

2/10 2. Uncertain

Services

Banks have to pay the interest rate for demand deposits, in accordance with the rate ceilings if necessary, and this rate is changeable when the economy changes and prime rate & federal funds rates varied with some inflation levels. So the interest rate for deposits are not free funds for banks, this also adjust to the market level when there is no rate ceilings. However, when interest ceilings exist in the current U.S. market, demand deposits have different impact on a the interest exposure

because the rate for deposits is not determined by the competitive market but determined by the federal policy. Usually, the rate ceilings are lower than the rate in the competitive market. Small banks favor for the ceilings to maximise profit, which is calculated by the larger spread between ceiling rate & Fed. funds rate times the limited deposits. But large banks don't like this ceiling and tend to rely on the CD's (certificate deposits) to borrow more funds in the short run. Usually, CD's rate is free to change except for the deposits over $100,000 and is lower than federal funds rate. So CD's rate is sensitive to the interest rate exposure only in the short period. and the exposure of the rate can be adjusted to the market rate level in a short run.

8/10 3. Uncertain

By setting the reserve requirement, the fed could limit the scale of the financial intermediary sector in the past, because the certain % of deposits is required to save to the federal reserve.

Now, the banks enter into RP's to transfer government securities and other securities to finance the funds overnight or 30 days. they can borrow the funds cheaper than the federal funds rate and can get money when they need. also money market funds has no reserve requirements ~~so~~ Banks take advantage of the lower money market funds rate than the federal funds rate and increase their liquidity.

But demand deposits, time deposits, which are required Reserve requirement, are so large in the u.s market, therefore Federal Authorities can limit the scale more or less. Also Banks try to circumvent the rate ceilings and developed RP's and compensating balances to increase the funds.

10/10 4. No

if banks get the insurance, they can reduce the liquidity ratio and try to lend more to finance & sell money in Euro market & Fed funds market, because even if they run the bankruptcy the government guarantee the losses of bankruptcy.

So banks, with the insurance, are more likely to concentrate on the loans to increase the profit under interest rate exposure and liquidity exposure. Even if they don't have assets enough to lend money, they can lend to even uninsured customers. So a bank with the insurance can reduce the liquidity and rely more on liability management. On the other hand, banks without insurance concern with the liquidity ratio and are careful not to lack the liquidity fund available at emergency.

3/5 5. LIBOR -- London Interbank Offering rate. This is used a official international lending rate in the London market among banks. So when banks lack the funds available to finance, they lend money at the offering rate. This rate is sensitive to inflation rate, prime rate.

or

5/5 6. Euro - Placement market. This is the market for direct placement funds between banks; Significance is than banks can have access to funds at any time of needing funds.

3/5 7. Agreements between banks and borrowers. Banks ask borrowers to deposit some % of the loans in the bank without interest, and lend the amount at the lower interest rate than the straight loan to the customers. Significance is that, bank get liquidity funds to make straight loans to other customers while customers can take advantage of lower rate.

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8. AAA has to reduce the deposits available to make loans to customers because of reserve requirements. AAA has to increase the cost higher than the cost without the reserve requirement, because AAA has to borrow more money to finance the funds and Reserve requirement deposits produce not interest rate.

To increase funds available, AAA will use the repo's and compensating balances, which are not subject to reserve requirement and get enough funds to increase the liquidity. Also, AAA try to go into the commercial paper with lines of credit, CD's in the short period to increase the liquidity. AAA also diversify the funds collected from customers in the diversified portfolio market so that the cost to each customer declines.

so what do the banks do?