Chapter 22

FINANCIAL INSTITUTIONS

*Note:*This chapter broadly discusses and describes the operation and regulation of financial institutions. However, given the recent financial crisis and the unprecedented actions of the federal government and the Federal Reserve, there remains much that continues to happen on a regular basis regarding the financial and financial intermediary markets and how they will continue to be organized, operated, and regulated.

INTRODUCTION

The primary function of any financial system is to facilitate the allocation and deployment of economic resources both spatially and temporally and in an uncertain environment. In other words, the financial system needs to get people with investable funds together with people who need investable funds in the most efficient manner possible. The basic and essential functions any financial system must perform are:

* methods for clearing and settling payments;
* mechanisms for pooling resources (large-scale indivisible enterprise);
* ways to transfer economic resources through time and across distances;
* methods of managing risk and uncertainty;
* price information to help coordinate decentralized decision-making;
* ways of dealing with incentive problems created when one party to a transaction has information that another party does not or when one party acts as an agent for another (moral hazard, adverse selection).

In a world of perfect information, costless transactions, absence of economies of scale, absence of moral hazard and adverse selection, and no uncertainty – in other words, in a frictionless world – we would not need financial intermediaries. But we do not live in such a world. Consequently, various financial institutions and intermediaries have evolved to overcome these frictions and to improve the allocation of resources and economic efficiency.

Figure 22.1 shows a basic diagram of the financial system for transferring resources from those people/businesses without investment opportunities to those who have them. Broadly speaking, two channels funnel resources from lender/savers to borrower/spenders. The most direct route is through the financial markets – the various stock, bond, commodity, and other exchanges. However, even these exchanges are a sort of intermediary, because they provide a time and place for transactions, set rules and procedures, and monitor compliance. In other words, lender/savers still are not directly transacting with borrower/lenders.

The second route is through various financial intermediaries: commercial banks and other depository institutions, investment banks and brokerage firms, investment companies, mutual funds and other pooled investment intermediaries, and insurance companies, as well as other financial institutions.

Basically, households save for different reasons than firms invest. Households try to minimize risk and have their savings readily accessible, or liquid. Firms are risk takers and need funds that will be tied up for a long time. By pooling the funds of savers and making loans to individual businesses, financial intermediaries reduce the costs of negotiation and search. They also acquire expertise in both evaluating and monitoring investments. Some financial intermediaries also provide the liquidity households demand. Financial intermediaries reduce risk through diversification. They invest in a large number of projects whose returns, although uncertain, are independent of one another. Every household has a small stake in many projects. Together, financial intermediaries can achieve the average return on investment with greater certainty than any single household can.

This chapter will explain the role of banks and other depository institutions in the economy, the differences among the various depository institutions, the role of bank regulators, including both state and federal regulators, the role of the Federal Reserve System and the workings of the deposit insurance programs, the banking structure in the U.S., and the purpose and characteristics of a number of other financial intermediaries. These other financial institutions include finance companies, investment banks and brokerage firms, investment companies and mutual funds, and a number of other pooled investment financial intermediaries – unit trusts, REITs, mortgage-backed bonds, REMICs, exchange-traded funds, and insurance companies.

**Figure 21.1**

**Lender**

**-**

**Savers**

1. Households

2. Business Firms

3. Government

4. Foreigners

**Borrowers**

**-**

**Spenders**

1. Households

2. Business Firms

3. Government

4. Foreigners

**Financial**

**Markets**

**Financial**

**Intermediaries**

**Funds**

**Funds**

**Direct Finance**

**Indirect Finance**

**Funds**

**Funds**

**Funds**

**Lender**

**-**

**Savers**

1. Households

2. Business Firms

3. Government

4. Foreigners

**-**

**Borrowers**

**Spenders**

1. Households

2. Business Firms

3. Government

4. Foreigners

**Financial**

**Markets**

**Financial**

**Intermediaries**

**Funds**

**Funds**

**Direct Finance**

**Indirect Finance**

**Funds**

**Funds**

**Funds**

BANKS AND THE ECONOMY

Bank is a term people use broadly to refer to many different types of financial institutions. What people call their bank may be a bank and trust company, a savings bank, a savings and loan association, or other depository institution.

What Is a Bank?

Banks are privately owned institutions that, generally, accept deposits and make loans. Deposits are money people leave in an institution with the understanding that they can get it back at any time or at an agreed-upon future time. A loan is money lent out to a borrower to be generally paid back with interest. This action of taking deposits and making loans is called financial intermediation. A bank’s business, however, does not end there.

Most people and businesses pay their bills with bank checking accounts, placing banks at the center of our payments system. Banks are the major source of consumer loans – loans for cars, houses, and education – as well as main lenders to businesses, especially small businesses.

Financial economists often describe banks as our economy’s engine, in part because of these functions, but also because of the major role banks play as instruments of the government’s monetary policy.

How Banks Create Money

Banks cannot lend out all the deposits they collect, or they would not have funds to pay out to depositors. Therefore, they hold primary and secondary reserves. Primary reserves are cash, deposits due from other banks, and the reserves required by the Federal Reserve System. Secondary reserves are securities banks purchase that they may sell to meet short-term cash needs. These securities usually are government bonds. Federal law sets requirements for the percentage of deposits a bank must keep on reserve, either at the local Federal Reserve Bank or in its own vault. Any money a bank has on hand after it meets its reserve requirement is its excess reserves.

These excess reserves create money. The process works as follows, using a theoretical 20% reserve requirement: Mr. Saver deposits $500 in FirstBank. FirstBank keeps $100 of the deposit to meet its reserve requirement, but lends $400 to Ms. Loan. She uses the money to buy a car. The Motor Car Dealership deposits $400 in its account at SecondBank. SecondBank keeps $80 of the deposit on reserve, but then lends out the other $320 as its own excess reserves. When SecondBank lends that money, it gets deposited in ThirdBank, and the cycle continues. Therefore, in this example, the original deposit of $500 becomes $1,220 on deposit in three different institutions. This phenomenon is called the multiplier effect. The size of the multiplier depends on the amount of money banks must keep on reserve.

The Federal Reserve can contract or expand the money supply by raising or lowering banks’ reserve requirements. Banks themselves can contract the money supply by increasing their own reserves to guard against loan losses or to meet sudden cash demands. A sharp increase in bank reserves, for any reason, can create a credit crunch by reducing the amounts of money banks have available to lend.

How Banks Make Money

While public policymakers have long recognized the importance of banking to economic development, banks are privately owned, for-profit institutions. Banks generally are organized as corporations owned by stockholders. The stockholders’ stake in the bank forms most of its equity capital, which is a bank’s ultimate buffer against losses. At the end of the year, a bank pays some or all of its profits to its shareholders in the form of dividends. The bank may retain some of its profits to add to its capital. Stockholders also may choose to reinvest their dividends in the bank.

Banks earn money in three ways:

1. They make money from what they call the spread, or the difference between the interest rate they pay for deposits and the interest rate they receive on the loans they make.

2. They earn interest on the securities they hold.

3. They earn fees for customer services, such as checking accounts, financial counseling, loan servicing and the sales of other financial products (e.g., insurance and mutual funds).

Banks earn an average of just over 1% on their assets (loans and securities) every year. This figure is commonly referred to as a bank’s Return On Assets, or ROA.

A Short History

The first American banks appeared early in the 18th century to provide currency to colonists who needed a means of exchange. Originally, banks only made loans and issued notes for money deposited. Checking accounts appeared in the mid-19th century, the first of many new bank products and services developed through the state banking system. Today banks offer credit cards, automatic teller machines, individual retirement accounts, home equity loans, and a host of other financial services.

In today’s evolving financial services environment, many other financial institutions provide some traditional banking functions. Banks compete with credit unions, financing companies, investment banks, insurance companies and many other financial services providers. While some claim that banks are becoming obsolete, banks still serve vital economic goals. They continue to evolve to meet the changing needs of their customers, as they have for the past two hundred years. If banks did not exist, we would have to invent them.

Banks and Public Policy

Our government’s earliest leaders struggled over the shape of our banking system. They knew that banks have considerable financial power. Should this power be concentrated in a few institutions, they asked, or shared by many? Alexander Hamilton argued strongly for one central bank. That idea troubled Thomas Jefferson, who believed that local control was the only way to restrain banks from becoming financially (and, therefore, politically) too powerful.

The U.S. system has tried both ways and found each lacking in some way. The system has evolved so that the current system is a compromise or composite of both approaches. The U.S. financial system allows for a multitude of banks, both large and small. Both the federal and state governments issue bank charters for “public need and convenience,” and regulate banks to ensure that they meet those needs. The Federal Reserve controls the money supply at a national level. The nation’s individual banks facilitate the flow of money in their respective communities.

Because banks hold government-issued charters and generally belong to the Federal Bank Insurance Fund, state and federal governments have considered banks as instruments of broad financial policy beyond money supply. Governments encourage or require different types of lending. For example, they enforce nondiscrimination policies by requiring equal opportunity lending. They promote economic development by requiring lending or investment in banks’ local communities and by deciding where to issue new bank charters. Using banks to accomplish economic policy goals requires a constant balancing of banks’ needs against the needs of the community. Banks must be profitable to stay in business, and a failed bank does not meet anyone’s needs.

DIFFERENCES AMONG BANKS, THRIFTS, AND CREDIT UNIONS

Three major types of depository institutions exist in the United States: commercial banks, thrift institutions, which include savings and loan associations and savings banks, and credit unions.

These three types of institutions have become more like each other in recent decades, and their unique identities have become less distinct. They still differ, however, in specialization and emphasis, and in their regulatory and supervisory structures.

Commercial banks are the traditional department stores of the financial services world. Thrift institutions and credit unions are more like specialty shops that, over time, have expanded their lines of business to better compete for market share. Many states, in fact, grant thrift institutions the same powers as commercial banks.

Commercial Banks

Commercial banks generally are stock corporations whose principal obligation is to make a profit for their shareholders. Basically, banks receive deposits and hold them in a variety of different accounts, extend credit through loans and other instruments, and facilitate the movement of funds. While commercial banks mostly specialize in short-term business credit, they also make consumer loans and mortgages, and have a broad range of financial powers. Their corporate charters and the powers granted to them under state and federal law spell out the range of their activities.

States and the federal government each issue bank charters. State-chartered banks operate under state supervision and, if they fail, are closed under provisions of state as well as federal law. National banks are chartered and regulated by the Office of the Comptroller of the Currency (OCC), a division of the Treasury Department. Banks can choose between a state and federal charter when starting their business, and can also convert from one charter to another after having been in business. Commercial banks receive deposit insurance from the Federal Deposit Insurance Corporation (FDIC) through the Bank Insurance Fund (BIF). All national banks, and many state-chartered banks, are members of the Federal Reserve System.

Savings and Loan Associations and Savings Banks

Savings and loan associations and savings banks typically specialize in real estate lending, particularly loans for single-family homes and other residential properties. They are organized either as corporations owned by stockholders or as mutual companies owned by their depositors and borrowers. These institutions are referred to as thrifts, because they originally offered only savings accounts, or time deposits. Over the past few decades, however, they have acquired a wide range of financial powers and now offer checking accounts (demand deposits) and make business and consumer loans as well as mortgage loans. Most of these institutions still invest the bulk of their money in mortgages and real-estate-related loans.

Both savings and loan associations and savings banks may get their charters either from the federal Office of Thrift Supervision (OTS) or from a state government regulator. The Savings Association Insurance Fund (SAIF) insures most savings and loan associations. The Bank Insurance Fund (BIF) insures savings banks.

Generally, savings institutions must hold 65% of their loan portfolio in housing-related assets (loans) or other qualified assets to retain their charter, as well as their membership in the Federal Home Loan Bank System. This is called the Qualified Thrift Lender (QTL) test. Recent liberalization of the QTL test has allowed thrifts to use some non-housing assets to meet this requirement.

The number of thrifts declined dramatically in the late 1980s and early 1990’s as a consequence of the savings and loan crisis of the 1980s. Many thrifts closed or merged with others under the direction of the Resolution Trust Corporation, at an extraordinary cost to the U.S. taxpayers. However, the thrift industry has rebounded in recent years. The recapitalization of the thrift fund, a revitalized industry and legislative changes have made the charter – once thought doomed to extinction – an appealing route to financial modernization for some. Due to liberalization of the qualified thrift lender test, many insurance companies and securities firms, as well as commercial firms, are now able to qualify as unitary thrift holding companies and to own depository institutions, bypassing prohibitions in the Glass Steagall Act and the Bank Holding Company Act. Critics of a revitalized thrift charter have said that it has been too advantageous for a certain class of financial institutions, highlighting the need for broader financial modernization through federal legislation.

Credit Unions

Credit unions are cooperative financial institutions, formed by groups of people with a common bond. These groups of people pool their funds to form the institution’s deposit base. The group owns and controls the institution together. Membership in a credit union is restricted to people who share the common bond of the group that created the credit union and is, therefore, not open to the general public. For example, people working for the same employer, belonging to the same church or social group, or living in the same community would share a common bond that might serve as the organizing criteria for the credit union. Credit unions are nonprofit institutions that seek to encourage savings and make excess funds within a community available at low cost to their members.

Credit unions accept deposits in a variety of accounts. All credit unions offer savings accounts, or time deposits. The larger institutions also offer checking and money market accounts. Credit unions’ financial powers have expanded to include almost anything a bank or savings association can do, including making home loans, issuing credit cards, and even making some commercial loans. Credit unions are exempt from federal taxation and sometimes receive subsidies, in the form of free space or supplies, from their sponsoring organizations and/or communities.

Credit unions were first chartered in the U.S. in 1909, at the state level. The federal government began to charter credit unions in 1934 under the Farm Credit Association, and created the National Credit Union Administration (NCUA) in 1970. States and the federal government continue to charter credit unions. Almost all credit unions are insured by the National Credit Union Share Insurance Fund (NCUSIF), which is controlled by the NCUA. In many states, state-chartered credit unions are supervised by the state Department of Banking.

BANK REGULATORS

Bank regulation, or supervision, involves four federal agencies and fifty state agencies. At first glance this regulatory scheme seems hopelessly complicated, but it is not that hard to understand once one knows what each agency does.

State and Federal Charters

The system often is described as a dual banking system. This refers to the fact that both the states and the federal government issued bank charters for the need and convenience of their citizens. The Office of the Comptroller of the Currency (OCC) charters national banks. The state banking departments charter state banks. In addition, the Office of Thrift Supervision (OTS) charters federal savings banks and savings associations. The words national, federal or state in an institution’s name have nothing to do with where it operates – rather they refer to the type of charter the bank holds.

Chartering agencies ensure that new banks have the necessary capital and management expertise to meet the public’s financial and security needs. The chartering agency is an institution’s primary regulator, with front-line duty to protect the public from unsafe and unsound banking practices. Chartering agencies conduct on-site examinations to assess banks’ condition and monitor compliance with banking laws. They issue regulations, take enforcement actions and close banks if they fail.

The Federal Reserve System (Central Bank)

After the banking panics in 1893 and 1907, commercial banks supported provisions in the 1913 Federal Reserve Act that gave power to Federal Reserve Banks to provide an elastic money supply through their reserve lending to banks, control of the discount rate, and the Fed’s ability to supply or curtail credit through its open-market operations buying or selling government bonds. The passage of the Federal Reserve Act in 1913 was meant to correct some of the shortcomings of the national bank system that became apparent during the financial crisis of 1907. The legislative goals were to establish: (1) a monetary authority that would expand and contract the money supply in concert with the needs of the economy; (2) a lender of last resort that could supply additional reserves in times of financial contraction; (3) an efficient check clearing and collection system throughout the country; and (4) a more vigilant system of bank oversight and monitoring.

The organizational structure, goals, and role of the Federal Reserve System have evolved over the years with the changing political and economic environment. Today, most of the authority in the system resides in the seven-member Board of Governors and the Chairman of the Federal Reserve rather than in the 12 regional Federal Reserve Banks. The Federal Open Market Committee (FOMC) consists of the seven-member Board of Governors plus five of the presidents of the 12 Federal Reserve banks. See Figure 22.2 for a diagram of the Federal Reserves Organization and Function.

**Figure 22.2**

**Board of Governors**

**(7 appointed members)**

**o**

**Sets reserve requirements and**

**approves discount rates as part of**

**moneta**

**ry policy**

**o**

**Supervises and regulates member**

**banks and bank holding**

**companies**

**o**

**Establishes and administers**

**protective regulations in consumer**

**finance**

**o**

**Oversees Federal Reserve banks**

**Exercises**

**general**

**sup**

**ervision**

**Federal Reserve banks**

**(12 Districts)**

**o**

**Propose discount rates**

**o**

**H**

**old reserve balances for**

**depositary institutions and lend**

**to them at the discount window**

**o**

**Furnish currency**

**o**

**Collect and clear checks and**

**transfer funds for depositary**

**institutions**

**o**

**Handle U.S. government debt and**

**cash balances**

**Advise**

**Compose**

**Advisory Councils**

**o**

**Consumer**

**o**

**Federal**

**o**

**Thrift Institutions**

**Federal Open Market Committee**

**o**

**Directs open market operations (buying and selling of**

**U.S. government securities), which are the primary**

**instrument**

 **of monetary policy.**

The principal functions of the Federal Reserve are economic stabilization through management of the nation’s money supply and through its role as lender of last resort. The FOMC’s role in the banking system and the economy as a whole is extremely important because it sets the nation’s monetary policy and the level of financial institutions’ reserves. Therefore, it is responsible for the amount of money in circulation and for controlling the monetary base and, thus, the overall level of economic activity.

The Federal Reserve also regulates all bank holding companies. Its regulatory focus is not so much on the banks within a holding company as on the umbrella structure of the holding company itself. Holding companies must apply to the Federal Reserve to acquire new subsidiaries or to engage in new activities. The Fed monitors the capital condition and general financial health of holding companies, and may take enforcement actions against them. The Federal Reserve is also responsible for federal oversight of foreign banks operating in the United States.

With banks more able to meet an onslaught of deposit withdrawals through borrowing from the Fed at low interest rates (the discount rate) during periods of financial crisis, it was anticipated that the banking system could avoid future bank panics. Unfortunately, these aspirations clearly were thwarted in the Great Depression of the 1930s. Monetarist Milton Friedman has said the crash occurred because the Fed failed to do its job. It let the money supply contract by one-third, creating an oppressive deflation that caused tremendous hardships for debtors, business firms, and banks. Over half the banks operating in the late 1920s failed during the Great Depression.

In the Fed’s defense, at the time it was only empowered by the Federal Reserve Act to be the lender of last resort to commercial banks that were members of the Federal Reserve System – a minority of all banks. In addition, it could lend only to banks that could present eligible collateral. However, the Fed did not take aggressive enough action to expand bank credit sufficiently through its open-market operations. With half the banks failing within four years, clearly the American public needed something more extensive or aggressive to restore their confidence in the banking system. One approach was to provide some form of federally-sponsored deposit insurance.

The Deposit Insurer

The Vandenberg Amendment to the Banking Act of 1933 authorized the creation of a federally-sponsored deposit insurance program. This was formalized with the creation of the Federal Deposit Insurance Corporation (FDIC) on January 1, 1934. Initially, deposit insurance was to cover only $2,500 per deposit. The level of insurance coverage was quickly raised to $5,000 per deposit, where it remained until after World War II. The coverage was raised to $10,000 per account in 1950, to $20,000 in 1969, to $40,000 in 1974, to $100,000 in 1980, and temporarily to $250,000 in 2008. It is scheduled to return to $100,000 for most deposits after 2013. The $250,000 amount is permanent for certain retirement accounts, including IRAs.

The Federal Deposit Insurance Corporation (FDIC) currently insures the deposits of banks up to a maximum of $250,000 per account holder. All states require newly-chartered state banks to join the FDIC before they can accept deposits from the public. Under the 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA), both state-chartered and national banks must apply to the FDIC for deposit insurance. Previously, national banks had received insurance automatically with their new charters.

The FDIC is the federal regulator of the approximately 5,000 state-chartered banks that do not belong to the Federal Reserve System. It cooperates with state banking departments to supervise and examine these banks, and has considerable authority to intervene to prevent unsafe and unsound banking practices. The FDIC also has backup examination and regulatory authority over national and Fed-member banks.

The FDIC deals with failed institutions by either liquidating them or selling the institutions to redeem insured deposits.

Savings and loan associations originally obtained federal deposit insurance from the Federal Savings and Loan Insurance Corporation (FSLIC), which was established by the National Housing Act of 1934. The FSLIC was allowed to offer insurance on the same terms as the FDIC. The FSLIC, however, incurred too many losses because of savings and loan failures during the savings and loan crisis of the 1980s. To preserve public confidence in deposit insurance, the FSLIC was eliminated in 1989 and replaced with the Savings Association Insurance Fund (SAIF) under the jurisdiction of the FDIC.

Since 1970, National Credit Union Share Insurance Fund (NCUSIF) has insured deposits in credit unions. The terms of the insurance are similar to FDIC insurance. Participating credit union accounts are federally insured up to $250,000. All federally chartered credit unions must acquire insurance issued by the NCUSIF, and state-chartered credit unions can elect to obtain NCUSIF insurance, provided they comply with NCUSIF requirements.

Federal deposit insurance is not free. Each insured institution can be assessed a fee, expressed as a percentage of deposits, to make sure the insurance funds will have sufficient reserves to cover all their losses. In addition, each insured institution must be federally examined and comply with appropriate federal laws and regulations to ensure that they are not taking excessive risks. Deposit insurance is valuable to the insured institutions, however, because it helps them retain public confidence and usually allows them to pay lower interest rates to depositors than they would have to pay if they were not insured.

Why So Many Different Regulators?

Many people have said that we would never design our current regulatory system as it is if we were starting from scratch. But our current system has evolved with the country, and has changed with the country’s needs.

The states were the first to charter banks in the United States. The federal government chartered the First and Second Banks of the United States in the early 19th century. These were the first national banks, and they performed functions similar to today’s Federal Reserve System. From 1837, when the Second Bank’s charter expired, to 1863, there were no national banks and no federal regulators.

The National Bank Act of 1863 created the Office of the Comptroller of the Currency, and authorized it to charter national banks. The original purpose of both the OCC and national banks was to circulate a universal currency, thus making tax collection easier and helping to finance the Civil War. The dual banking system took shape in the late 19th century, as states reformed their chartering policies and regulatory systems in response to the National Bank Act.

A series of money shortages early in the 20th century made it clear that the country needed some central authority to monitor and control the money supply. The Federal Reserve Act of 1913 established this authority through a network of twelve Federal Reserve Banks, overseen by a Board of Governors. The Federal Reserve System had regulatory authority over all its member banks. This was the first time a federal agency had direct authority over state-chartered banks, although state bank membership in the Federal Reserve was voluntary.

The Banking Act of 1933 created the FDIC, as noted above, in response to the avalanche of bank failures that followed the stock market crash of 1929. The 1933 Banking Act also required all state-chartered banks to join the Federal Reserve within a certain period of time or lose their deposit insurance, but this requirement eventually was repealed. The FDIC established its own standards for state nonmember bank acceptance into the fund.

Bank holding companies were new corporate entities that began appearing in the 1940s. The banks were all regulated, but no one regulated the holding company subsidiaries that were not banks, and no one watched the flow of resources among affiliates within the holding company. The Bank Holding Company Act of 1956 gave the Federal Reserve regulatory responsibility for these companies, while leaving the supervision of banks within holding companies in the hands of their traditional regulators.

In 1989, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) expanded the FDIC’s supervisory and enforcement authority, and extended its responsibilities to include the thrift deposit insurance role formerly held by the Federal Savings and Loan Insurance Corporation (FSLIC).

In 1991, FDICIA also expanded the authority of federal regulators to intervene in troubled institutions. FDICIA also mandated specific enforcement actions for unhealthy institutions – the first time prescribed early intervention provisions had been included in federal statutes.

In 2007, what was to be the worst financial crises since the Great Depression hit the U.S. and became global. The Great Recession - as it has come to be known - uncovered systemically poor industry practices that undermined ever single aspect of the financial services industry. The recession hit the mortgage industry extremely hard. The crisis devalued property in every state, crippled lenders, exposed unsound and unethical lending practices, and crippled banks and corporate giants.

In response to the crisis, and in an effort to protect consumers and the business environment of the country, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act which was signed into law on July 21, 2010, by President Barack Obama. The stated purpose of the law is to create a sound economic foundation to grow jobs, protect consumers, rein in Wall Street, end bailouts, end “too big to fail” corporations, and prevent another financial crisis.

Although experts say the recession officially ended in June 2009, the effects continued to linger into 2012 and later, with high unemployment figures and low labor participation rates persisting for several more years.

The Dodd-Frank Act represents a significant change in the American financial regulatory environment affecting all Federal financial regulatory agencies and affecting almost every aspect of the nation’s financial services industry.

The comprehensive law provides for new regulations affecting U.S. banking, securities, derivatives, executive compensation, consumer protection and corporate governance. The law created the Consumer Financial Protection Bureau, the Office of Financial Research, and the Office of National Insurance, all under the auspices of the Department of Treasury. It also created the Financial Stability Oversight Council, which is chaired by the Federal Reserve Board Chairman..

In addition to the new agencies, other federal agencies tasked with creating new rules and conducting studies include the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation (FDIC), the Federal Housing Finance Agency (FHFA), the Federal Reserve (FRB) , the Federal Trade Commission (FTC), the Government Accountability Office (GAO), the Department of Housing and Urban Development (HUD), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), the Securities and Exchange Commission (SEC) and the Treasury.

The major highlights of the Dodd-Frank Act were the following:

*Consumer Protections with Authority and Independence:* Created a new independent watchdog, housed at the Federal Reserve, with the authority to ensure American consumers get the clear, accurate information they need to shop for mortgages, credit cards, and other financial products, and protect them from hidden fees, abusive terms, and deceptive practices.

*Ends Too Big to Fail Bailouts:* Ended the possibility that taxpayers will be asked to write a check to bail out financial firms that threaten the economy by: (1) creating a safe way to liquidate failed financial firms; imposing tough new capital and leverage requirements that make it undesirable to get too big; (2) updating the Fed’s authority to allow system-wide support but no longer prop up individual firms; and (3) establishing rigorous standards and supervision to protect the economy and American consumers, investors and businesses.

*Advance Warning System:* Created a council to identify and address systemic risks posed by large, complex companies, products, and activities before they threaten the stability of the economy.

*Transparency & Accountability for Exotic Instruments:* Eliminated loopholes that allowed risky and abusive practices to go on unnoticed and unregulated — including loopholes for over-the-counter derivatives, asset-backed securities, hedge funds, mortgage brokers and payday lenders.

*Executive Compensation and Corporate Governance:* Provided shareholders with a say on pay and corporate affairs with a non-binding vote on executive compensation and golden parachutes. Provided tough new rules for transparency and accountability for credit rating agencies to protect investors and businesses.

*Enforces Regulations on the Books:* Strengthened oversight and empowers regulators to aggressively pursue financial fraud, conflicts of interest and manipulation of the system that benefits special interests at the expense of American families and businesses.

BANK GEOGRAPHIC STRUCTURE

In banking, the term geography refers to the area in which banking activities are allowed to take place, such as interstate banking, and intrastate and interstate branching. While even banking experts often confuse the terms, they have distinctly different meanings.

Intrastate Branching

Intrastate branching refers to branching within a particular state. Permitting banks to open more than one office or branch originated at the state level, and the states have directed the expansion of banks’ geographic boundaries. Earlier in the 20th century, few banks had more than one office. Today, most banks can open branches throughout their respective states. A great majority of the 50 states allow statewide branching, and other states allow limited branching. Many banks have expanded their branch network to better meet the needs and convenience of their customers.

The 1927 McFadden Act sought to give national banks competitive equality with state-chartered banks by letting national banks branch to the extent permitted by state law. The McFadden Act specifically prohibited intrastate branching by allowing a national bank to branch only within the city in which it is situated. Although the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 repealed this provision of the McFadden Act, it specified that state law would continue to control intrastate branching, or branching within a state’s borders, for both state and national banks.

Of note, there are approximately 9,500 savings and loan branches that, because of preemptive authority in the law establishing the thrift charter, are subject to neither intrastate nor interstate branching restrictions. This preemptive authority was intended to foster a national market for home mortgages.

Interstate Banking

Interstate banking refers to the ability of a bank holding company to own and operate banks in more than one state. Under the Douglas Amendment to the Bank Holding Company Act of 1956, states controlled whether, and under what circumstances, out-of-state bank holding companies could own and operate banks within their borders.

The need for the Douglas Amendment grew from the concern that bank holding companies were evading the McFadden Act and state branching laws by acquiring numerous subsidiary banks in various states, and then operating these banks as if they were branches. The development of these interstate bank networks was a significant factor leading to Congress’ passage of the Bank Holding Company Act of 1956. Senator Douglas emphasized that a primary purpose of his amendment was “to prevent an undue concentration of banking and financial power, and instead keep the private control of credit diffused as much as possible.”

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 repealed the Douglas Amendment. On September 29, 1995, federal law allowed full nationwide banking across the country, regardless of state law. Another provision of the Riegle-Neal Act allows affiliate banks within bank holding companies to effectively act as branches for each other, accepting deposits, collecting payments, and providing other customer services.

Interstate banking has resulted in increased consolidation and concentration in the banking industry. While the United States had 14,399 banks in 1940, the country has fewer than 6,500 banks in December 2014. However, while consolidation among banks has certainly been the trend, the number of branches in the U.S. has steadily increased. In other words, consumers have more banking outlets than ever in our country’s history.

Interstate Branching

Interstate branching means that a single bank may operate branches in more than one state without requiring separate capital and corporate structures for each state, that is, without the holding company organizational structure. The state of New York approved the first interstate branching statute in 1992. This law set several requirements and conditions on New York branches of out-of-state banks. It also required reciprocity; that New York banks were allowed to branch into the home states of banks that branch into New York. Other states passed similar laws.

The 1994 Riegle-Neal Interstate Banking and Branching Efficiency Act allowed national banks to operate branches across state lines after June 1, 1997. This federal law allows branching through acquisition only, which means that a bank must acquire another bank and merge the two structures in order to operate branches across state lines.

The Riegle-Neal Act allowed states to opt-out of interstate branching by passing a law to prohibit it before June 1, 1997. A state that opted-out of interstate branching prevented both state and national banks from branching into or out of its borders. Texas and Montana were the only states to “opt-out” of interstate branching.

States also have the power to authorize de-novo branching across state lines, which would allow a bank to simply open a new branch in another state instead of having to acquire an entire bank. Several states have decided to allow de-novo branching; however, most of them have done so on a reciprocal basis.

In 1997, the Riegle-Neal Amendments Act was signed into law ratifying an agreement between the states, the FDIC and the Federal Reserve allowing seamless supervision for state-chartered banks that branch across state lines.

Foreign Banks

The term foreign bank generally refers to any United States operation of a banking organization headquartered outside of the U.S.

The first foreign banks established their presence in the United States in the mid-1800s with New York being the first state to license or regulate these institutions. While state governments took the lead in welcoming foreign banks to the United States, the federal government has also acted to ensure that American markets are open to banks from all nations.

Today foreign banks are a significant presence in the American financial system, providing many important benefits to individuals, businesses, and the general economy. In fact, foreign banks make almost 40% of all loans to American businesses.

Foreign banks most often come to the United States to provide services to American subsidiaries of clients in their home countries or to a specific group of individuals. Once here, however, they provide a wide range of wholesale banking services. They are most active in New York, California, Florida, Illinois and Georgia, but also maintain operations in several other states.

Foreign banking organizations can acquire or establish freestanding banks or bank holding companies in the United States. These banks are regulated and supervised as domestic institutions. Generally, however, it is more cost-effective and productive for foreign banking organizations to operate as another of several available structures: branches, agencies, loan production offices, representative offices, and Edge Act (described below) or agreement corporations. Each of these business structures has a different set of powers and regulatory requirements.

Branches and agencies are the most common structures of foreign banking organizations in the United States. The major difference between these two types of banking offices is that branches may accept deposits, while agencies generally may not. Both structures can make and manage loans, conduct foreign exchange activities and trade in securities and commercial paper. These offices may conduct most of the activities a domestic bank performs. The primary exception is that foreign banks and branches may not accept deposits of less than $100,000 unless they had FDIC insurance prior to December 19, 1991. State governments and the Office of the Comptroller of the Currency separately license and supervise foreign bank branches and agencies. The Federal Reserve serves as the federal regulator of state-licensed foreign bank branches and agencies, in a system similar to that for domestic banks. More than 85% of the foreign bank branches and agencies in the U.S. are state licensed/chartered.

Foreign banks may also establish representative offices in the United States. Representative offices have more limited powers than branches or agencies. Foreign banks often open representative offices as a first step in establishing a presence in America. These offices serve as a liaison between the parent bank and its clients and correspondent banks in the U.S. They may develop relationships with prospective clients, but they cannot conduct any banking transactions themselves. Representative offices must register with the Federal Reserve, and may be licensed by states as well.

Edge Act and agreement corporations are foreign bank offices chartered by the Federal Reserve (Edge Act) or states (representative corporations) to provide financing for international trade. Domestic banking organizations may also establish Edge Act or agreement corporations. These offices have a broader range of powers than other banking organizations, but all of their activities must relate to international trade. Other structures available to foreign banks are commercial lending corporations, licensed by New York State, and export trading companies.

In order to protect American consumers and the overall stability of the U.S. financial system, states and federal banking agencies regulate and supervise foreign banking operations in the United States. The major Federal laws affecting foreign banks in the United States are the International Banking Act (IBA) of 1978 and the Foreign Bank Supervision Enhancement Act (FBSEA) of 1991. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 and the Gramm-Leach-Bliley Financial Modernization Act of 1999 also address foreign bank operations in the U.S.

State and federal bank supervisors recently unveiled a new system for supervising and examining foreign banks in the United States. Under this system, state and federal bank regulators work together to provide a seamless overview of a foreign bank’s entire U.S. operation, which may encompass several states. Because foreign bank branches and agencies are arms of their parent banks, their supervisory structure must be slightly different from that used for domestic institutions. Supervisors evaluate an office’s risk management, operational controls, compliance with state and federal laws, and asset quality. The Federal Reserve also looks at the overall support U.S. offices receive from their parent banks. Foreign-owned banks that have deposit insurance must comply with all U.S. consumer laws and pay premiums to the FDIC. All lenders must comply with federal fair lending issues.

Foreign banks in the United States are an important source of new capital for American businesses. Because their parents are not as deeply affected by fluctuations in the U.S. economy as their domestic counterparts, U.S. offices of foreign banks can provide credit even during domestic credit crunches. In short, foreign banks in the United States are valuable corporate citizens and an essential part of the American financial system.

OTHER FINANCIAL INTERMEDIARIES

Trust Companies

A trust company is a corporation authorized to act as a trustee or in other fiduciary capacities. It is somewhat of a historical accident that corporate trustees are regulated as banking institutions, but a trust company does not necessarily need to be a bank in the normal sense of the term. Some trust companies act as stand-alone trust companies that do not take deposits or make loans and which may or may not be affiliated with a bank. Many banks, of course, exercise trust powers directly through trust departments. Three alternative forms of trust company charters currently are used:

* State-Chartered Trust Company. The laws of approximately 40 states, including California, allow the establishment of stand-alone trust companies that do not take deposits or make loans and are not affiliated with a bank. The California Department of Financial Institutions (DFI) licenses trust companies in California.
* National Trust Company. The Office of the Comptroller of the Currency (OCC), which charters and regulates national banks, may authorize the creation of a "national trust company," i.e., a bank that limits its activities to the exercise of trust powers.
* Thrift Limited to Trust Powers. The Office of Thrift Supervision (OTS), which charters federal savings associations (commonly called thrifts), recently has begun to issue charters for federal thrifts limited to trust powers.

While particular regulatory requirements and limitations must be examined on a case-by-case basis, practically anyone can establish, own, and operate a trust company. This includes natural persons, financial services institutions such as broker-dealers, investment advisory firms, insurance companies, and national or state-chartered banks and savings associations, or their holding companies, and non-financial commercial or industrial firms.

The fundamental trust company franchise is the legal authority to engage in the business of holding and managing other people's money for compensation. Technically, this means acting in a fiduciary or representative capacity (e.g., trustee, executor, guardian, conservator, investment adviser or manager, agent, custodian, and similar capacities) and providing services necessary or incidental to carrying out responsibilities imposed by fiduciary laws. The specific nature and scope of trust company business activities are defined by state law. Federally-chartered trust institutions are authorized to engage, generally, in activities co-extensive with those permitted by competing state-chartered institutions.

Statutory and regulatory minimum capitalization requirements for state-chartered institutions vary widely, ranging from as low as $100,000 to as high as $8 million. Applicants for federal charters can expect minimums in the vicinity of $3-5 million. The amount required also will depend on the nature and scope of the trust company's business activities.

Trust companies have two sets of legal and regulatory requirements to contend with:

* Federal and state laws applicable to particular fiduciary relationships govern a trust company's responsibilities as trustee or fiduciary. The Employee Retirement Income Security Act of 1974 (ERISA), for example, imposes standards and responsibilities on trustees and fiduciaries of private employee benefit plans. State laws, such as the Trust Law contained in the California Probate Code, govern fiduciary responsibilities to personal trusts and other non-ERISA trusts.
* A trust company also is subject to intersecting and sometimes inconsistent and overlapping laws governing the activities of the trust company itself as a business entity. As a result, choosing a trust company charter requires careful consideration of the applicable regulatory scheme in light of the organizers' business objectives. A few examples of these regulatory issues are referenced in a chart towards the end of this Client Alert.

Because trust companies are subject to regulation substantially similar to that applicable to banks, they enjoy many of the same exemptions from securities and other laws.

The laws of many states on the geographic limits on trust company operations are based on the notion that trust institutions are authorized to market and provide trust services only to citizens of the state in which the institution is based and chartered. While efforts are being made to ease barriers to interstate operations, these laws pose obstacles at least for state-chartered trust companies. The OCC and the OTS, on the other hand, have issued opinions to the effect that national trust companies and federal thrifts may establish limited purpose trust offices in any state that allows state-chartered banks and trust companies and other institutions the right to act as fiduciaries. Although federally-chartered institutions are subject to certain state requirements (e.g., security deposits with the state treasurer), laws restricting or prohibiting out-of-state institutions from providing or marketing fiduciary services in or to the state are, according to the OCC and OTS, preempted.

In short, federally-chartered trust companies currently have a clear advantage over state-chartered trust companies in terms of interstate operations. Nevertheless, this is an evolving and still somewhat confused area. The OCC and OTS interpretations have not been tested in court, and several states have been reluctant to concede jurisdiction over out-of-state institutions, whether federal or state chartered. Institutions considering interstate operations thus should monitor current developments on a state-by-state basis. One thing, however, is clear: the modern mobility of customers, increasing competition from national financial services providers, and the communications revolution has made the trust and investment management business a truly national, indeed international, business.

Finance Companies

Finance companies make loans to both consumers and business. Like credit unions, consumer finance companies were established in the early 1900s to provide a source of funds for small borrowers. Because commercial banks did not serve the needs of small consumer borrowers at the beginning of the 20th century, many people borrowed from loan sharks, who charged exorbitant interest rates and frequently used quite abusive collection practices for bad debts. The problem was that small loans were so costly to service that no legal lender could afford to make such loans at the prevailing legal rate ceiling as set by the usury laws of the time in each state. Given this problem, many states enacted laws that: (1) would allow specially chartered consumer finance companies to charge relatively high legal loan rates on small loans; and (2) severely restricted the type of collection methods that such institutions could use.

Finance companies generally do not have federal insurance; some finance companies have obtained industrial bank charters in a few states or have qualified as non-bank banks so they can issue FDIC-insured deposits. They also do not have a specific federal regulator. However, they are subject to state regulation and to the Fair Trade and Debt Collection Practices rules of the Federal Trade Commission. In addition, they are potentially subject to antitrust laws. Finally, they are subject to Federal Reserve regulations that regulate credit rate disclosure, prohibit credit discrimination, etc. In general, finance companies tend to hold more capital in reserve relative to their assets than other depository institutions because their deposits are not federally insured.

Investment Banks and Brokerage Firms

Investment banking identifies, structures, and executes diverse and innovative public and private market transactions, helping clients in both developed and emerging markets to achieve their most important strategic and financial objectives. More specifically, an investment bank is an individual or institution that acts as an underwriter or agent for corporations and municipalities issuing securities. Most also maintain broker/dealer operations, maintain markets for previously issued securities, and offer advisory services to investors. Investment banks also have a large role in facilitating mergers and acquisitions, private equity placements, and corporate restructuring. Unlike traditional banks, investment banks do not accept deposits from and provide loans, other than margin loans, to individuals.

An investment bank is a financial institution that generally has two primary focuses: (1) sales and trading of securities; and (2) investment banking. The sales and trading side, called the retail or brokerage side, deals with all types of securities and how both individuals and institutions wish to invest their money. The investment banking side primarily deals with corporate finance and all types of transactions pertaining to it.

The brokerage side is the part of the investment banking business with which most small investors are most familiar. Investors wishing to invest in individual securities must set up an account with a brokerage firm to handle the transactions. The types of brokerage accounts include cash accounts, margin accounts, which permit the investors to borrow to buy securities and to sell securities short, and managed accounts, where the brokerage firm is given authority to make transactions on behalf of the investor, rather than just executing the trades indicated by the investor.

Through the brokerage account, investors place their buy and sell orders for stocks, bonds, options, futures, and other securities and the brokerage firm executes the trades for a fee, called the commission, through its representative on the floor of the appropriate exchange or market. Investors can place a number of different types of orders such as market orders (to buy or sell immediately at the current market price), limit orders (which include good-until-canceled orders: keep the order open and buy or sell when the security reaches the specified price or until cancelled, fill-or-kill orders – if the order cannot be executed at the specified price immediately, it is cancelled, Additionally, there are day orders – (when the order is not executed by the end of the day, it is cancelled),and stop-loss orders (buy or sell the security if it reaches a specified price).

The brokerage firm keeps track of all trades and issues regular reports, accounts for all cash received on sales and paid for purchases, credits the accounts for all dividends and interest received on securities held in street name[[1]](#endnote-1) as well as debiting the accounts for any interest paid on margin loans, monitors the adequacy of margin and issues margin calls when necessary to meet margin requirements, and monitors all pending or outstanding orders. In addition, firms may provide more or less in the way of investment research, advice, and recommendations. Typically, the commission that investors pay on purchases and sales of securities depends on the level of service. Full service brokers who provide extensive research and advice charge higher commissions. However, most brokerage firms now offer discount, no-frills, brokerage services that provide no specific advice or recommendations and just complete the investor’s desired transactions. The commissions are correspondingly lower. In the case of managed accounts, the brokerage firm often does not charge commissions, per se, but rather charges a regular comprehensive fee as a percentage of the value of assets being managed.

The major players in the industry, when classified on the basis of size, include Goldman Sachs, Barclay’s, Citi, Credit Suisse, Deutsche Bank, Morgan Stanley, UBS, JP Morgan Chase, Bank of America and Merrill Lynch. These large firms are known as the bulge bracket but a large number of other firms form the sizeable second tier of investment banks. When viewed from the perspective of providing pure investment banking services as compared to a mix of financial services, Goldman Sachs is an example of a bank dealing almost exclusively in investment banking services. JP Morgan Chase and Deutsche Bank, on the other hand, have diversified by providing a combination of investment and commercial banking services. There are also some small, specialized banks, called boutiques, such as Allen & Co. and Lazard Freres, that are oriented towards a specific aspect or niche of investment banking like bond trading, merger and acquisition advisory, or technical analysis.

The revenues from investment banking crossed $200 billion in 2000, amounting to 0.6% of the world's GDP. It is very difficult to gauge the exact size of the industry simply because the industry environment is extremely volatile and a lot of the firms are still private firms. A fair idea about the decline of investment banking can be gauged from the fact that global securities underwriting (one of the key investment banking services), dropped from $3.9 trillion in 2002 to $2.1 trillion in 2011. As far as profits go, an investment-bank, through underwriting, typically makes four times the profit that a traditional bank does through issuing an ordinary loan.

The scope of investment banking has widened in the U.S. since 1999 with the repeal of Glass-Steagall Act and the passing of the Gramm-Leach-Bliley Act. This legislation has brought down the barriers between commercial and investment banking. As a result, investment banks are increasingly venturing into the markets and financial services traditionally performed by commercial banks. Under the new legislative environment, a broader and better definition of investment banking is as an industry that either trades directly in capital market products or uses the underlying capital markets to construct different financial products.

In this new emerging and competitive environment, the kinds of services investment banks are offering include:

* underwriting initial public equity offerings (IPOs) of traditional and new equity issues and bond issues such as mortgage bonds, Eurobonds, etc.;
* sales and trading of fixed income products like government bonds, Eurobonds, money market instruments, asset swaps, corporate bonds, municipal bonds, asset-backed securities, floating-rate notes, mortgage bonds, bond options and more;
* sales and trading of stocks listed on stock exchanges or unlisted securities;
* sales and trading of the whole range of derivative instruments based on underlying equity, fixed income, foreign exchange, credit, and commodity markets (e.g. sugar, oil, and gold);
* advising, structuring, launching, and financing mergers and acquisitions of companies;
* management of funds on behalf of pension funds, life insurance companies, and other institutional portfolios in global capital markets;
* helping companies raise funds needed for new projects by determining the amount of funds needed and the means of raising it, through equity, debt, convertibles, preferred, asset-backs or derivative securities;
* conducting research on markets, industry, economic conditions, credit, to give buy or sell recommendations to investors regarding specific stocks or bonds or other securities;
* managing investment assets of private wealthy individuals;
* providing private banking services for large individual investors.

Investment Companies and Mutual Funds

Investment companies allow a large number of relatively small investors to pool their resources and purchase shares in a diversified portfolio. Diversification permits investors to participate in relatively risky investments because only a small percentage of their assets are actually invested in the securities of any one company. To achieve this level of diversification without resorting to mutual fund ownership, an investor would have to have a substantial amount of capital. Purchasing a large number of different securities in less than round lots, that is, in lots of less than 100 shares, is rather expensive. Also, the record keeping involved would be rather burdensome.

Open-End Funds and Closed-End Funds

Investment companies come in essentially two flavors: open-end funds and closed-end funds. Open-end investment companies are usually referred to as mutual funds. Mutual funds are by far the dominant form of investment company. The number of shares outstanding in a mutual fund depends on investor demand. When investors buy shares in the mutual fund, the mutual fund issues new shares. When investors redeem shares, the mutual fund reduces the number of shares it has outstanding. The net asset value (NAV) of a mutual fund is calculated at least once each day. Net asset value is found by taking the total market value of all securities and other assets owned by the fund, subtracting any liabilities, and dividing by the number of shares in the fund. For example, if at the end of the day a mutual fund has a net asset value of $100 million and 2.5 million shares outstanding, the fund has a net asset value of $40 a share.

Closed-end investment companies have a fixed number of shares outstanding. Once they commence operations, they do not normally issue and redeem shares of stock in the fund. Their purpose is to purchase (invest in) other securities. To purchase shares in a closed-end investment company, an investor must buy them in the market from another investor who wants to sell. The investor does not purchase shares from the investment company. At any moment, the value of the shares of a closed-end investment company is determined by the supply and demand for those particular securities. While net asset value is important, there is no guarantee that the fund will be selling at or near its net asset value. Often closed-end investment companies trade at a discount or premium to net asset value. It is possible to find the prices of closed-end investment company stocks selling 15 to 20% greater or less than their net asset value.

Why Investment Companies Arose

Investment companies arose and are considered financial intermediaries because they were able to provide small investors with a number of advantages that they, usually, could not achieve in the securities markets on their own. These advantages included professional management, better investment diversification, a broader range of investment opportunities, convenience, better record-keeping and other investment information, greater liquidity, and protection through regulation.

*Professional management*. Professional management helps investors because most small investors do not have the time to properly select and manage a portfolio of securities. This often requires research and the analysis of extensive amounts of data. This job often is best turned over to a professional portfolio manager who specializes in investing and managing investments for others. Professional portfolio managers have greater access to the quantitative tools needed to evaluate financial data, to evaluate the quality and ability of a firm’s management, and to assess the level of competition in an industry. Thus, they can better make an informed judgment as to the timing of buying and selling individual securities.

*Diversification*. Purchasing shares of a mutual fund gives the investor immediate diversification. An investor can acquire a portfolio of securities that meet the investor’s objectives. For instance, if the investor’s objective is aggressive growth, the purchase of a mutual fund with this same stated objective for several thousand dollars could result in a portfolio of 50 or 100 stocks that together meet the investment criteria.

There are many different types of diversification:

* One can diversify among different asset categories, for example, stocks versus bonds versus money market instruments versus real estate.
* One can diversify among different industries, for example, computer versus autos versus entertainment versus retailing.
* One can purchase shares of, and thus diversify, among different companies such as IBM, Wal-Mart, General Motors, and AT&T.
* One can also diversify among different countries by purchasing stocks of companies headquartered in the United States, Germany, Great Britain, and Australia.

*Range of investment opportunities*. There are thousands of funds from which to choose. Mutual fund companies typically offer investors a family of funds, each having different investment objectives. For example, some of the funds may be growth funds, growth and income funds, or specialty funds that concentrate investments in a specific industry such as health care. Also, within a family of funds, investors are able to move from different types of investments, that is, they can shift money from stock funds to bond funds. Care should be taken however when switching from one fund to another, even within a family. For instance, unless the investment is in a tax-deferred account such as a 401(k) plan or an IRA, every time one fund is sold and another purchased there are income-tax consequences – if there is gain on the shares of the fund sold, taxes are recognized on the gain. Also, attempts at market timing by switching into and out of various mutual funds or between stocks and cash are rarely successful.

*Convenience*. Mutual funds generally offer automatic reinvestment plans through which dividends and capital gains are reinvested in additional shares of the fund. Also, transfers between funds in the same family can usually be made by telephone or electronic account transfers. This provides investors with additional flexibility if they decide to change their asset allocation.

*Record keeping and investor information*. Whenever transactions are made, statements are sent to the investor confirming the transactions. They typically show the date and the amount of shares purchased or sold. Also, investors receive periodic statements from mutual fund companies showing the balance in their account and any activity during the statement period. Mutual fund statements also serve as a convenient source of information when preparing income taxes. Some mutual fund companies provide investors with a statement of the average cost of the shares that they have sold. This aids in calculating the gain or loss for tax purposes. Finally, most mutual fund companies provide telephone and even on-line access to account information. The investor can get up-to-date information on the balance of the investor’s account, the date of the next dividend, as well as general facts about the fund.

*Liquidity*. Investors can sell closed-end fund shares whenever the markets are open or redeem mutual fund shares daily at net asset value, giving the investor quick access to the funds.

*Regulation*. Investment companies are highly regulated, which helps to insure that management treats investors in a legal and ethical manner.

*Low cost*. Investing in no-load mutual funds is a very low-cost method of acquiring a diversified portfolio.

Money-Market Mutual Funds (MMMFs)

Perhaps the closest substitute for a depository account in a bank is the money-market mutual fund. MMMFs were designed to invest in short-term, highly liquid money-market securities, such as T-bills, CDs, commercial paper, and other notes generally with a term to maturity of less than one year and offer yields that are generally quite favorable compared to interest paid on deposits in bank checking and savings accounts. In addition, most money market mutual funds and some short-term bond funds offer check-writing privileges, so they are essentially direct competitors to bank checking accounts. Generally, the owner can write checks against the balance in the owner’s account, usually subject to a minimum, such as $100, $250 or $500 per check.

Other Pooled Investment Intermediaries

A whole host of additional pooled investment opportunities have arisen for investors for the same reasons as those that led to the growth of investment companies, and the number keeps growing. Among these pooled investments are unit trusts, real-estate investment trusts (REITs), mortgage-backed bonds, real-estate mortgage investment conduits (REMICS), and exchange-traded funds (ETFs). A brief description of each of these types of pooled investments follows.

Unit Trusts

A unit investment trust is a pool of unmanaged investments. A trust agreement is drawn up under which the trust holds a portfolio of securities for safekeeping. Once the portfolio is established, it is not actively traded. More often than not, they invest in fixed-income investments such as corporate and/or government bonds or mortgages. As the bonds mature, the proceeds are distributed, rather than reinvested, as would generally be the case with a closed-end investment company. Brokerage houses usually put these trusts together. Units in the trust are then sold to the public, usually at a price of $1,000 a unit. The sponsoring organization handles routine record keeping, collects any coupons or dividends, and distributes the income to the trust holders.

REITs

Real estate investment trusts (REITs) are essentially publicly traded closed-end investment companies that invest in a managed, diversified portfolio of real estate or real estate mortgages and construction loans rather than in financial securities such as stocks and bonds. Although REITs are corporations or trusts, they are not subject to tax at the corporate level if they distribute at least 95% of their net annual earnings to shareholders and meet certain other requirements. Investors must pay the tax on a REIT’s earnings as the earnings are distributed. Therefore, REITs allow investors to share, with limited liability, the financial and tax benefits of real estate while avoiding the double taxation inherent in corporate ownership.

Investors have three types of REITs from which to choose: (1) equity REITs; (2) mortgage REITs; and (3) hybrid REITs. Equity REITs acquire ownership interests in commercial, industrial, or residential properties. Income is primarily received from the rentals of these properties. Mortgage REITs invest in real estate indirectly by lending funds for construction and/or permanent mortgages. In some cases, mortgage REITs invest in mortgage-backed securities such as Ginnie Mae or other mortgage-backed obligations. Hybrid REITs combine the features of both equity and mortgage REITs by investing both in real estate and mortgages or loans secured by real estate, similar to a balanced mutual fund investing in stocks and bonds.

Mortgage-Backed Securities

A mortgage-backed bond or security is a debt issue that is backed or secured by a pool of mortgages. For instance, the Government National Mortgage Association (GNMA) assembles home mortgages and issues securities based on the total amount of mortgages in the pool. Such securities are referred to as pass-through securities or participation certificates, and investors can purchase them in denominations of $25,000. The average life of these securities is around eight to 10 years, even though the original maturities may be as long as 30 years. Because the securities are backed by home mortgages, as mortgages are paid off early, the life of the securities is typically less than the original maturity date would indicate.

If interest rates drop, the rate at which these mortgage-backed obligations are paid off usually increases. The problem here is that investors do not lock in a high interest rate for as long a period as they originally hoped. On the other hand, if mortgage interest rates rise, the rate at which these mortgages are paid off should slow down and investors will be stuck holding securities that pay lower than current market interest rates for a longer period of time than they might like. Also, the security holder has to realize that the payments being received are part interest and part principal. Unlike traditional bonds, at maturity there is no lump-sum principal to be received. The investor should be reinvesting principal payments and not treat the interest portion of the distributions as spendable income.

REMICs

Real estate mortgage investment conduits are limited-life, self-liquidating entities that invest exclusively in real estate mortgages or in securities backed by real estate mortgages. They issue two types of securities – regular interests and residual interests. There may be many classes of REMIC regular interests, that is, REMIC bonds, but only one class of residual interest. REMIC bonds are treated for tax purposes as debt securities. The bonds receive a specified cash flow from the underlying pool of mortgages, similar to mortgage-backed bonds such as Ginnie Mae.

Real estate mortgage investment conduits were developed to solve the problem of the prepayment uncertainty that exists with typical mortgage-backed securities. A REMIC divides the payouts on a pool of mortgages into tranches, or segments, based on the investors’ preferences for a short-term, intermediate term, or long-term investment. Typically, all investors receive periodic interest payments, but principal payments are another matter. The short-term class receives principal payments first. After those securities are retired, the next or intermediate-term tranche receives principal payments until those securities are retired. Finally, principal payments go to the long-term investors.

REMICs are essentially derivative securities – securities that were created from other securities, in this case from mortgage-backed bonds. The mortgage-backed bonds are placed in a trust and REMIC interests, which are participation certificates in the trust, are sold to the public. Their credit ratings are very high because they are typically made up of mortgage-backed bonds that are backed or guaranteed by the U.S. government.

Regular REMIC interests are not subject so much to default risk as they are to prepayment risk. Some of the short-duration tranches have very little or no prepayment risks. Other longer-term tranches carry a disproportionate share of the prepayment risk and their price movements are very volatile.

Residual interests are treated for tax purposes much like interests in a partnership or trust. They are roughly comparable to an equity interest in the REMIC entity. Whatever income is not paid to the REMIC bondholders goes to the residual interest holders in the REMIC.

REMICs are flow-through entities, similar to mutual funds, and are typically exempt from the federal income tax. A REMIC terminates when all mortgages are repaid.

Exchange-Traded Funds

On the simplest level, as the name implies, an exchange-traded fund (ETF) is a basket of securities, like a mutual fund. However, ETFs are traded, like individual stocks, on an exchange. They are something of a hybrid, combining features of both closed-end and open-end mutual funds, as well as other unique features.

ETFs represent shares of ownership in funds, unit investment trusts, or depository receipts that hold portfolios of common stocks that closely track the performance and dividend yield of specific indexes. They give investors the opportunity to buy or sell an entire portfolio of stocks in a single security as easily as buying or selling a share of stock. They offer a wide range of investment opportunities.

ETFs bear exotic names, such as Qubes, SPDRs, sector SPDRs, MidCap SPDRs, HOLDRs, iShares, VIPERs, and DIAMONDS. Most of them are passively managed, tracking a wide variety of sector-specific, country-specific, and broad-market indexes. However, some of the newer ETF offerings are actively-managed funds. In addition, sponsors are creating new ETFs covering various market sectors, market indexes, or international markets nearly every day.

Broad-based funds track a broad group of stocks from different industries and market sectors. For example, iShares S&P 500 index fund (symbol IVV) is a broad-based ETF that tracks the S&P 500. Sector funds track companies represented in related industries. Another, iShares Dow Jones U.S. Healthcare Sector Index Fund (symbol IYH), is a sector ETF that tracks the Dow Jones Healthcare sector. International funds track a group of stocks from a specific country or a broad index of international stocks such as the MSCI–EAFE index. The iShares MSCI–Australia (symbol EWA) tracks the Morgan Stanley Capital International index for Australian stocks.

While similar to index mutual funds, ETFs differ from mutual funds in significant ways. Unlike index mutual funds, ETFs are priced and can be bought and sold throughout the trading day. Furthermore, ETFs can be sold short and bought on margin. Essentially, anything investors might do with an individual stock, they can do with an ETF.

One of the most important characteristics that make ETFs different from mutual funds or closed-end funds is the redemption feature.

ETFs can be redeemed for the underlying securities. Generally, only large institutional investors or very wealthy investors can avail themselves of this feature, because the minimum in-kind redemption is generally at least 50,000 shares. However, this creates an arbitrage opportunity if prices in the market differ significantly from the net asset value. Consequently, in contrast with closed-end mutual funds, market arbitrage generally keeps ETFs trading close to their net asset values. Although the trading prices for ETFs do not always equal their net asset values, they rarely, if ever, trade at the significant discounts and premiums from net asset value that characterizes market prices for closed-end funds.

Insurance Companies

Life Insurance Companies

Insurance companies essentially are another type of investment pooling intermediary with a twist. The twist is that they also provide a mechanism for risk sharing and risk transfer.

Similar to other investments, the principal economic purpose of life insurance is to accumulate capital. Although most commentators stress that people should not view life insurance principally as an investment, the authors of this text disagree. That is what life insurance really is: a superb investment vehicle. All conventional investment vehicles serve the same purpose, but the unique feature of life insurance is that it assures a desired accumulation at a specific, but uncertain, time, namely at the time of the insured’s death. No other investment makes such a guarantee. It accomplishes this goal by pooling the investments of many investors and, through actuarial calculations, sharing the risk among all investors so that each will receive the desired investment accumulation at their uncertain time of death.

If the time of death were not uncertain, life insurance would be unnecessary. A person could accumulate any desired target amount by investing in a traditional investment vehicle and employing a systematic plan of saving, or what is called a sinking fund. For example, if a person’s objective is to accumulate $1,000 in five years and he or she could be assured of surviving that long, this person could simply invest a specific lump-sum amount today in a traditional investment vehicle that with interest would grow to $1,000 in 5 years. For instance, if $620.92 is invested today at 10% interest, the fund will grow to $1,000 in 5 years. Alternatively, if this person does not have $620.92 to invest today, he or she could finance the accumulation over time, for instance, by investing $148.91 at the beginning of each year for the next five years. However, if this person died any time before the end of the 5-year period, they would accumulate at the time of death less than the desired $1,000. Life insurance essentially is an investment mechanism that assures the desired accumulation by the time of death regardless of when death occurs.

Most discussions of life insurance describe it as a combination of pure death protection that decreases and saving or investment that increases over a person’s lifetime. Many people are confused by this distinction because it is confusing and misleading. Properly viewed in its entirety, life insurance is a special type of investment or accumulation vehicle that matures at death. However, one can employ this bifurcation between death protection and savings elements usefully if one understands it for what it really is. The savings component is the noncontingent part of the overall investment accumulation that is available not just at death, but also during life, similar to any conventional investment or savings instrument.

What people call the pure death protection component of life insurance is actually a contingent investment; that is, the part of the overall investment accumulation that matures or becomes available only upon death. The relative size of these two components depends on the life product and how the owner finances the life insurance. At one extreme is annually renewable term insurance, which is essentially 100% pure death protection and 0% savings. At the other extreme are deferred annuities during the accumulation phase (and other conventional investments) that are essentially 0% pure death protection and 100% savings.[[2]](#endnote-2) The other life insurance products lie somewhere between these extremes.

Making the distinction between the pure death protection and savings components actually ignores half the spectrum of life products. Actuaries often describe annuities in a manner analogous to life insurance, as a combination of pure life protection and savings elements after the annuity starting date. The savings component of annuities is the noncontingent part of the overall investment that is available regardless of whether one lives or dies, similar to any conventional investment or savings instrument.

In other words, the savings component is the guaranteed or refund amount provided by some annuities that is payable even if the annuitant dies. The pure life protection component is a contingent investment that matures or is available only if the annuitant *lives*. At one end of this spectrum are full-refund or term-certain annuities (or conventional investments) that are essentially 100% savings and 0% pure life protection. At the other end of the spectrum are no-refund life annuities that are 0% savings (theoretically) and 100% pure life protection.[[3]](#endnote-3)

**Figure 22.3**

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| **DEATH PROTECTION, LIFE PROTECTION, AND SAVINGS ELEMENTS OF LIFE PRODUCTS** |
| ◄════════════ Death Protection ═════════════ | Increasing | ══════  Life Protection ══════► |
| Annually Renewable Term | Level Premium N-Year Term | Modified and Graded Premium Whole Life | Level Premium Whole Life | Limited-Pay Whole Life | Single-Premium Whole Life (Endow-ments) | Deferred Annuity During Accumulation Phase (Conventional Investments) | Full Refund and Term-Certain Annuity | Life Annuity with Period Certain or Partial Refund | Pure Life Annuity with No Period Certain or Refund |
| ════════════════════════════► | Increasing Savings Component | ◄════════════ |

Figure 22.3 shows how various life products from term insurance to annuities fall within the pure death/life protection and savings element spectra. But keep in mind that both components comprise the total investment. Any assessment that evaluates the investment potential of a life product by looking only at the savings element, the amounts which are available regardless of whether a person lives or dies, ignores the fact that the pure death/life protection component is properly viewed as a type of contingent investment that matures or is available only when the death or life contingency occurs.

A common misconception about life insurance is that the risk of premature death is transferred to the insurance company. Although insurance companies must have a certain amount of surplus or paid-in capital to cover potential excess losses, they price their products to maintain or even increase the surplus and paid-in capital over time. Therefore, risk is shifted to or shared among all insureds in the insurance pool. Those policy owners who live a long time carry the economic burden for those who do not. However, there is less risk sharing with premium-payment plans that generate a greater savings component, such as single-premium life insurance, than with those that have a greater pure death protection component, such as annually renewable term. The savings component, similar to other investments, can be viewed as a form of self-insurance, because it is available regardless of whether the insured lives or dies. If the self-insurance component is greater, the amount of risk that must be shared among all participants in the pool is obviously less.

Property, Casualty, Liability, Health, Disability and Other Insurance Companies

Similar to life insurance companies, these other insurers are intermediaries that pool the resources of many people to share and transfer the risk of various potential loses. Through payment of actuarially determined premiums, all the policyholders essentially split the cost of any loses for any of the insureds so that no one insured has to bear the burden of a catastrophic loss. Once again, if we could accurately predict the timing, incidence, and magnitude of all losses for each insured, we would need no market for this insurance. But because nobody knows for sure just who will incur losses, when they will occur, or the magnitude of the losses, people are willing to pool their resources and share the losses for the betterment of everyone.

CHAPTER ENDNOTES

1. . Most cash accounts and all margin and managed accounts are in street name, meaning, the brokerage firms actually hold the securities of their customers in the brokerage firm’s name. The brokerage firms place entries in the individual investor’s accounts indicating their ownership of various securities held by the firm in street name. The investor accounts do not actually have the stock certificates or bonds or other evidences of securities in their accounts. [↑](#endnote-ref-1)
2. . The life insurance product closest to a 0% pure death protection and 100% savings combination is a single-premium endowment policy. An endowment policy essentially is a whole life policy that will mature or endow, that is, pay the face amount of coverage, if the insured is still alive at a specified age, such as age 65. Similar to other life insurance products, it also pays the face amount if the insured dies before the policy endows. By analogy, traditional whole life policies really are endowment policies that endow at age 95 or 100. [↑](#endnote-ref-2)
3. . Even pure no-refund life annuities mayhave some savings component or provide some element of recovery even in the event of death because owners sometimes may exchange them for annuities with refund or guaranteed features, companies may permit the annuitant to surrender all or a part of the annuity for its commuted value, or, in very limited circumstances and in limited amounts, the insurer may permit the annuitant to take loans against the annuity’s cash value. [↑](#endnote-ref-3)