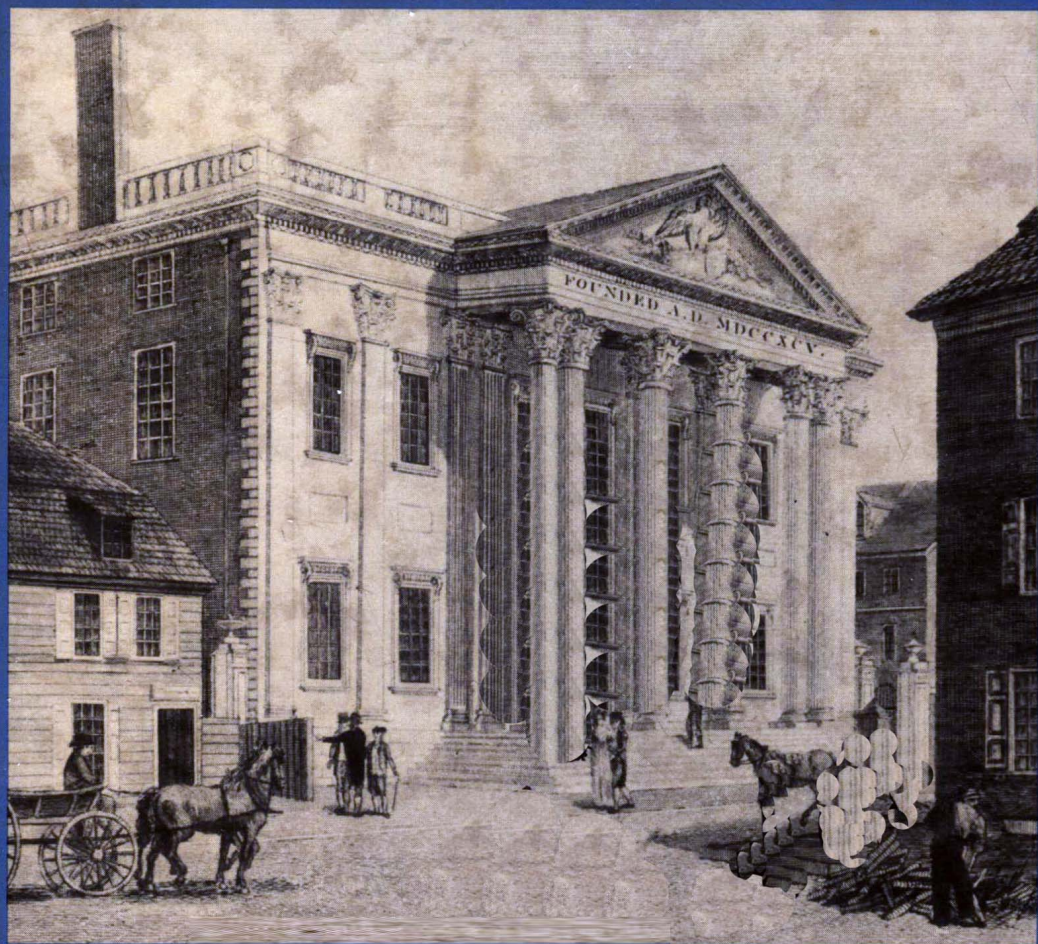


Fourth Edition

COMMERCIAL BANKING



Edward W. Reed / Edward K. Gill

fourth edition

COMMERCIAL BANKING

Edward W. Reed, Ph.D.

*Senior Vice President
and Economist, Retired
United States National Bank of Oregon*

Edward K. Gill, Ph.D.

Boise State University



Prentice Hall
Englewood Cliffs, New Jersey 07632

LIBRARY OF CONGRESS
Library of Congress Cataloging-in-Publication Data

Reed, Edward Wilson
Commercial banking. -- 4th ed. / Edward W. Reed, Edward K. Gill.
p. cm.
Rev. ed. of: Commercial banking / Edward W. Reed ... et al. 3rd
ed. c1984.
Includes bibliographies and index.
ISBN 0-13-154360-1
1. Banks and banking--United States. I. Gill, Edward K.
II. Commercial banking. III. Title.
HG2491.C64 1989
332.1'2'068--dc19

88-15735
CIP

Editorial/production supervision and
interior design: Nancy Savio-Marcello
Cover design: Ben Santora
Manufacturing buyer: Ed O'Dougherty

Cover photos courtesy of Library of Congress and Citibank, N.A.



© 1989, 1984, 1980, 1976 by Prentice-Hall, Inc.
A Division of Simon & Schuster
Englewood Cliffs, New Jersey 07632

All rights reserved. No part of this book may be
reproduced, in any form or by any means,
without permission in writing from the publisher.

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

ISBN 0-13-154360-1 01

PRENTICE-HALL INTERNATIONAL (UK) LIMITED, London
PRENTICE-HALL OF AUSTRALIA PTY. LIMITED, Sydney
PRENTICE-HALL CANADA INC., Toronto
PRENTICE-HALL HISPANOAMERICANA, S.A., Mexico
PRENTICE-HALL OF INDIA PRIVATE LIMITED, New Delhi
PRENTICE-HALL OF JAPAN, INC., Tokyo
SIMON & SCHUSTER ASIA PTE. LTD., Singapore
EDITORA PRENTICE-HALL DO BRASIL, LTDA., Rio de Janeiro

PREFACE

This book is about the business of commercial banking—and that business has undergone rapid change in recent years as banks have confronted volatile economic conditions and revised regulations. Banks are seeking profits and accessing funding sources in ways new to them. At the same time, nonbank competition in traditional banking activities has increased dramatically. This revision of *Commercial Banking* attempts to depict the new environment in which bank management must operate.

There is a danger, however, that writers of textbooks on banks will focus too extensively on the new elements in banking, forgetting that most of what banks do is what they have done for many years: accept deposits and make loans and investments. New methods may have some influence on how these activities are carried out, but the basic business is unchanged.

Nor has the importance of commercial banks diminished because of changes in the environment. Commercial banks make funds available to meet the needs of individuals, businesses, and governments. In so doing, they facilitate the flow of goods and services and the activities of governments. The commercial banking system provides a large portion of our medium of exchange and is the primary instrument through which monetary policy is conducted.

The ability of our commercial banking system to perform its tasks efficiently and in harmony with our needs and economic goals depends in

large measure on effective management. Banks must be managed prudently, safely, and profitably if we are to have a strong, adaptable banking system capable of meeting the needs of society.

This book reviews the management aspects of commercial banks. It has been written with the objective of providing students and professionals with a description and analysis of the operations of commercial banks. It is an investigation into the techniques and principles employed by commercial banks in the performance of their many functions. Although the focus is on management and the individual bank, the book does not lose sight of the social and monetary importance of the banking system.

Lending is the major business of commercial banks, and more bank personnel are involved in the lending activity than in any other. In recognition of its importance, we devote seven of the nineteen chapters to lending. In addition, the text covers structure, organization and management, deposits, cash and liquidity management, investments, trust services, and international banking. Two chapters are devoted to two areas of vital importance, profitability and bank capital. Because of the quasi-public nature of banking, we consider each of these topics in light of the laws and regulations under which banks operate.

We are indebted to many people, both practitioners and academicians. We are particularly grateful to Richard V. Cotter and Richard K. Smith. Information and suggestions have been provided by so many people that we are reluctant to attempt to list all of them, but to each one we owe a debt of gratitude.

CONTENTS

PREFACE	xv
1 COMMERCIAL BANKING: AN OVERVIEW	1
Functions of Commercial Banks	1
Creating Money, 3	
Payments Mechanism, 3	
Pooling of Savings, 4	
Extension of Credit, 4	
Facilities for the Financing of Foreign Trade, 6	
Trust Services, 6	
Safekeeping of Valuables, 7	
Brokerage Services, 8	
A Brief Look at Assets and Liabilities	9
Competitive Environment	13
Deregulation of Banking, 17	
2 STRUCTURE OF THE BANKING SYSTEM	24
Early History of Banking	24
Dual Banking	26
Organization of Banking	28
Branch Banking, 28	

Number of Commercial Banks and Commercial Banking Offices	29
<i>Member and Nonmember Banks,</i>	30
Incorporation of Commercial Banks	30
Correspondent Banking	31
Supervision of Commercial Banking	33
Foreign Banks in the United States	37
Bank Holding Companies	40
<i>Multibank Holding Companies,</i>	40
<i>One-Bank Holding Companies,</i>	42
<i>Activities of Bank Holding Companies,</i>	45
Chain Banking	49
Nonbanks	50

3 EXPANSION OF COMMERCIAL BANKING

52

Mergers of Commercial Banks	52
<i>Reasons for Merging,</i>	53
<i>Merging and the Courts,</i>	55
<i>Is Banking a Line of Commerce?</i>	58
<i>Competition in Banking,</i>	59
<i>Increase in Mergers,</i>	61
<i>Merger Guidelines,</i>	63
Establishing Branches	64
The Issue of Interstate Banking	67
<i>Present Status of Interstate Banking,</i>	70
Franchising	73

4 MANAGEMENT, DECISION MAKING, AND INTERNAL ORGANIZATION OF BANKS

77

Decision Making in Commercial Banks	78
Planning	78
<i>Objectives,</i>	80
<i>Policies,</i>	80
<i>Rules,</i>	82
<i>Strategy,</i>	82
Communication	83
Controlling	84
<i>Reports,</i>	85
<i>Audit,</i>	85
<i>Examination,</i>	86
Planning and Decision Making by Departments	87
Bank Organization	88
<i>Organization in Small Banks,</i>	90
<i>Organization in Large Banks,</i>	93
The Board of Directors	98
<i>Requirements of Bank Directors,</i>	98

Responsibilities of Bank Directors, 99	Functions of the Board of Directors, 99	Liabilities of Bank Directors, 102
Administrative Officers	106	

5 ASSET MANAGEMENT

110

Commercial Bank Assets	113
Cash Assets	114
<i>Legal Reserves, 114</i>	<i>Vault Cash, 115</i>
<i>Correspondent Bank Balances, 116</i>	
Security Investments	116
Bank Loans	117
Priority Classes of Assets	117
Primary Reserves, 118	Secondary Reserves, 118
<i>Loan Portfolio, 119</i>	<i>Investment for Income, 120</i>
Allocation Methods	120
<i>The Pool of Funds Approach, 120</i>	<i>The Asset Allocation Approach, 121</i>
<i>Programming Model, 124</i>	
Liquidity of Assets	127
Liquidity Measurement	128
Determining Liquidity Needs	130
Theories of Bank Liquidity Management	134
<i>The Commercial Loan Theory, 134</i>	<i>The Shiftability Theory, 135</i>
<i>The Anticipated Income Theory, 135</i>	
Management of the Reserve Position	136

6 LIABILITY MANAGEMENT

140

Transaction Accounts	141
Savings and Time Deposits	142
Level of Deposits in the Commercial Banking System	143
Deposits at Individual Banks	144
Increased Cost of Deposits	147
Clearing and Collection of Checks	147
Liability Management for Liquidity	148
<i>The Discount Window, 149</i>	<i>Federal Funds, 150</i>
<i>Repurchase Agreements, 151</i>	<i>Eurodollar Borrowing, 151</i>
<i>Large Certificates of Deposit, 152</i>	

Asset-Liability Management	152
<i>Net Interest Margin, 153</i>	<i>Gap Management, 153</i>
<i>Duration Analysis, 154</i>	<i>Asset-Liability</i>
<i>Management Problems, 155</i>	<i>Hedges, Asset Sales,</i>
<i>and Interest Rate Swaps, 156</i>	

7 MANAGEMENT OF CAPITAL FUNDS AND SAFETY OF BANKS

159

The Capital Debate	160
Definition of Bank Capital	161
Functions and Growth of Bank Capital	162
<i>Protective Function, 162</i>	<i>Operational Functions,</i>
<i>164</i>	<i>Regulatory Functions, 164</i>
<i>Growth of Bank</i>	<i>Capital, 165</i>
Sources of Bank Capital	166
<i>Common Stock, 166</i>	<i>Reserves for Loan</i>
<i>Losses, 167</i>	
Preferred Stock, Capital Notes, and	
Debentures	167
<i>Preferred Stock, 169</i>	<i>Capital Notes and</i>
<i>Debentures, 170</i>	
Variations in the Sources of Bank Capital	171
Composition of Bank Capital	172
Adequacy of Bank Capital	173
<i>Capital Ratios, 174</i>	
Bank Capital and Bank Size	178
<i>Criticisms of Ratios and Formulas, 179</i>	
Safety of Commercial Banks	181
Issue of FDIC Assessment	186

8 PROFITABILITY OF BANKS

189

Income from Bank Loans	189
<i>Factors Affecting Bank Loan Rates, 192</i>	
Income from Securities	193
<i>Securities Gains and Losses, 193</i>	
Other Sources of Income	194
<i>Trust Department Income, 194</i>	<i>Service Charges</i>
<i>on Deposit Accounts, 194</i>	<i>Other Operating</i>
<i>Income, 195</i>	

Bank Expenses	195
Salaries, Wages, and Employee Benefits,	196
Interest on Time and Savings Deposits,	196
Federal Funds, 196	Occupancy Expense, 197
Provision for Loan Losses, 197	Other Operating
Expenses, 197	Income Taxes, 198
Commercial Bank Profits	199
Measurement of Bank Profits, 200	Profitability of
Banks, 201	Profitability and Bank Size, 204
Future Prospects for Bank Profits,	205
Dividend Policy	206
Variations in Bank Profitability	208
Functional Cost Analysis	209
The Need for Adequate Profits,	213

9 CREDIT ANALYSIS

216

Objectives of Credit Analysis	216
Factors Considered in Credit Analysis	217
Capacity to Borrow, 217	Character, 218
Ability to Create Income, 219	Ownership of Assets, 219
Economic Conditions, 220	Relative Importance of
the Credit Factors, 221	
Scope of Credit Investigation	221
Sources of Credit Information	222
Interview of Loan Applicant, 222	Bank's Own
Records, 223	External Sources of Credit
Information, 223	Inspection of Applicants' Places
of Business, 227	Financial Statements, 227
Analysis of Financial Statements	227
Evaluation of Items on the Financial	
Statements	229
Evaluation of Asset Items, 229	Evaluation of
Liabilities and Net Worth, 231	Evaluation of the
Income Statement, 232	Evaluation of the
Statement of Changes in Financial Position,	233
Ratio Analysis	233
Liquidity and Activity Ratios, 237	Financial
Leverage, 239	Profitability, 240
Ratio Trends, 241	
Sources of Comparative Financial	
Information	242
Cash Budgets and Pro Forma Financial	
Statements	243

10 LENDING PRACTICES AND POLICIES 246

- Classification of Loans 246
 - Purpose, 246 Secured and Unsecured Loans, 247 Maturity, 248 Method of Repayment, 249 Origin, 249
- Regulation of Bank Lending 250
- Loan Policy 252
- Factors That Influence a Bank's Loan Policies 252
- Items Included in a Loan Policy 254
 - Loan Territory, 254 Types of Loans to Be Made, 254 Acceptable Security and Creditworthiness, 254 Maturities, 255 Excess Lines, 256 Loan Liquidation, 256 Problem Loans, 256 Compensating Balances, 256 Loan Commitments, 257 Size of the Loan Portfolio, 258
- Loan Pricing 259
 - Rates on Business Loans, 260 Interest Rates on Farm Loans, 262 Interest Rates on Consumer Loans, 262 Residential Real Estate Interest Rates, 263 Usury, 263
- Administration of the Loan Policy 263
- Organization of Bank Lending 264

11 SHORT-TERM BUSINESS AND FARM LOANS 268

- Businesses That Borrow on a Short-Term Basis 268
- Credit Lines 270
- Unsecured Short-Term Business Loans 271
- Secured Short-Term Business Loans 272
 - Endorsed or Comaker Loans, 272 Assignment of Contracts, 273 Assignment of Accounts Receivable, 274 Factoring, 276 Assignment of Oil Runs, 277 Loans Secured by Inventories, 277 Uniform Commercial Code and Floating Liens, 281 Loans Secured by Plants and Other Real Estate, 282 Loans on Securities, 282 Loans Secured by Life Insurance, 284
- Loans to Farmers 284
 - Indirect Lending, 287

12 INTERMEDIATE-TERM BUSINESS LOANS

289

- Term Loans 289
- Reasons for the Growth of Term Loans 290
- Businesses Using Term Loans 290
- Use of Term Loan Funds 290
- Maturity, Security, and Method of Payment of
Term Loans 292
- Interest Rates 293
- Loan Participations and Guaranteed Loans 294
- Sources of Repayment for Term Loans 295
- Factors Considered by Banks in Term
Lending 295
 - Internal Factors, 296 Creditworthiness of the
Borrower, 297*
- The Term Loan Agreement 298
 - Preamble, 298 Amount and Term of the Loan,
298 Representations and Warranties, 299
Conditions of Lending, 299 Description of
Collateral, 300 Covenants of the Borrower, 300
Restrictive Clauses, 301 Events of Default, 302*
- Revolving Credit 303
- Leasing 304
 - Leveraged Leasing, 304 Tax Advantages, 305*
- Organizing and Administering a Leasing
Program 306

13 REAL ESTATE LENDING

308

- Residential Real Estate Loans 309
 - Secondary Mortgage Market, 310*
- Types of Residential Loans Made by Commercial
Banks 311
- Significant Steps in Residential Real Estate
Lending 312
 - Credit Analysis of the Borrower, 313 Appraisal of
Property, 313*
- Terms of Residential Real Estate Loans 315
 - Enforceable Lien, 315 Mortgage, 315 Repayment
Provisions, 317*
- Adjustable Rate Mortgages 318

Second Mortgages	318
Truth in Lending	319
Mobile Home Loans	319
Land Development and Construction Loans	320
Nonfarm, Nonresidential Real Estate Loans	322
Farm Real Estate Loans	323
Mortgage Banking	324

14 LOANS TO CONSUMERS

326

Classification of Consumer Credit	326
<i>Installment Consumer Credit</i> , 327	<i>Terms of</i>
<i>Consumer Installment Credit</i> , 329	<i>Noninstallment</i>
<i>Consumer Credit</i> , 332	
Origin of Consumer Loans	332
<i>Reasons for Indirect Lending</i> , 332	<i>Dealer</i>
<i>Reserves</i> , 333	<i>Significant Factors Involved in</i>
<i>Indirect Lending</i> , 333	<i>Credit Factors Involved in</i>
<i>Indirect Financing</i> , 335	<i>Floor Planning</i> , 336
Credit Cards	337
Automated Teller Machines (ATMs)	342
Point-of-Sale Payment System	342
Regulation of Consumer Credit	343
<i>Truth in Lending</i> , 344	<i>Equal Credit Opportunity</i>
<i>Act</i> , 345	<i>Holder-in-Due-Course Doctrine</i> , 346
<i>Fair Credit Billing Act</i> , 347	
Loans for the Purchase and Carrying of	
Securities	348

15 PROBLEM LOANS

351

Recent Loan Losses	354
Causes of Problem Loans and Losses	355
<i>Consumer Loans</i> , 355	<i>Loans for Productive</i>
<i>Purposes</i> , 356	<i>Imperfect Lending Practices</i> , 358
<i>Indicators of Problem Loans</i> , 359	
Personnel Concerned with Problem Loans	360
Prevention of Problem Loans and Loan	
Losses	361
Handling Problem Loans	362
<i>Workout Arrangements</i> , 364	<i>Liquidation of</i>
<i>Problem Loans</i> , 366	<i>Bankruptcy</i> , 368

16 THE INVESTMENT ACCOUNT: POLICIES AND MANAGEMENT **371**

- Characteristics of the Investment Account 371
- Objectives of the Investment Account 372
- The Risks Inherent in the Investment Account 374
- Bond Prices, Yields, and Maturities 375
- Investment Policy 377
 - Diversification, 378 Forecasting Interest Rates, 379 Quality Requirements, 382 Managerial Responsibilities, 382 Trading, 383 Hedging, 384*
- Determining the Organization of the Investment Department 385

17 INVESTMENT SECURITIES **389**

- Investment Regulations Pertaining to National Banks 389
- Determination of Quality 391
- Classification of Eligible Securities According to Obligor 392
 - Federal Government Securities, 392 Issuing Treasury Securities, 394 The Dealer Market, 394 Government Agency and Related Issues, 395 Municipal Securities, 395 Municipals and the 1986 Tax Reform Act, 397 Passthrough Securities, 398 Collateralized Mortgage Obligations, 399 REMICs, 400 Other Securities, 400*
- Bank Underwriting of Municipal Securities 400
- Trends in Bank Investments 402

18 TRUST SERVICES OF COMMERCIAL BANKS **406**

- Advantages of a Corporate Trustee 406
- Development and Regulation of Trust Services in Commercial Banks 408
- Trust Services Performed for Individuals 408
 - Settlement of Estates, 409 Administration of Personal Trusts, 410 Serving as Guardian and Conservator of Estates, 411 Performance of Agencies, 412*

Trust Services Performed for Businesses	413
Trust Services Performed for Charitable Institutions and Others	415
Responsibilities of Trust Departments	415
Potential Liabilities of Trust Departments	416
Trust Investment Policies and Objectives	417
<i>The Pursuit of Investment Performance</i>	419
<i>Common Trust Funds</i>	420
Amount and Makeup of Trust Assets	421
Trust Department Organization	421
Fees of Trust Departments	423

19 INTERNATIONAL BANKING

427

Development of International Banking	428
<i>The Edge Act</i> , 429	International Banking
Facilities, 430	Expansion Abroad, 430
Reasons for the Growth of International Banking	433
International Services of U.S. Banks	434
Transfer of Funds	435
Financing International Trade	436
<i>Bills of Exchange</i> , 437	<i>Letters of Credit</i> , 437
<i>Bankers' Acceptances</i> , 439	<i>Export Financing</i> , 441
Collections	441
Foreign Exchange Market	442
Making a Market, 443	Exchange Risks, 446
and Forward Rates, 446	
International Lending	448
<i>Risks of International Lending</i> , 448	<i>Types of</i>
Loans, 451	<i>Insurance and Guarantees</i> , 452
Eurodollar Lending, 453	
Foreign Debt Crisis of the 1980s	455
<i>Hazards of Foreign Lending</i> , 455	<i>Causes of Debt</i>
Crisis, 456	<i>Signs of Trouble</i> , 457
Impact of	<i>Heavy Indebtedness</i> , 457
Some Improvement,	458
Trouble in Latin America, 459	<i>Debt Crisis</i>
of the 1980s Not the First, 461	<i>Who Is to Blame?</i>
461	<i>The Outcome?</i> 462

INDEX

465

1

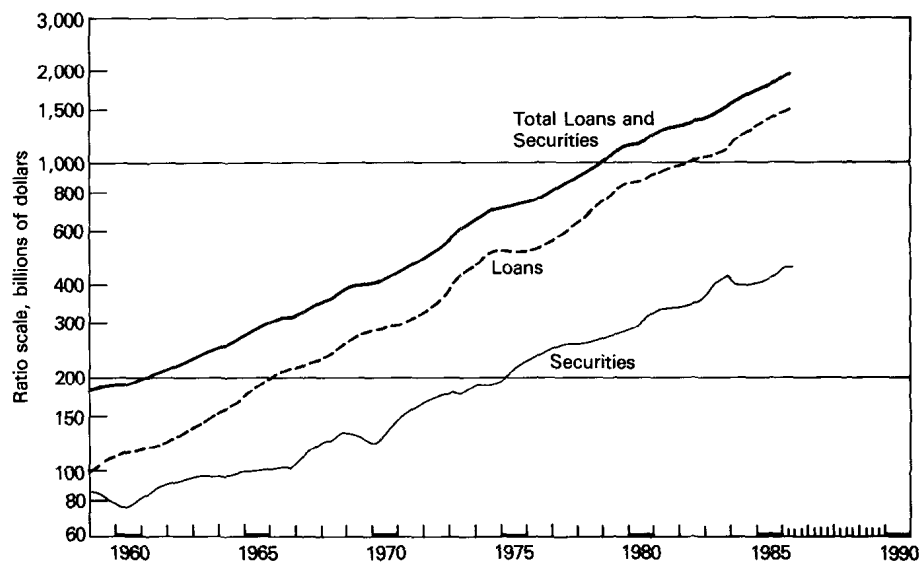
COMMERCIAL BANKING: AN OVERVIEW

Commercial banking is one of our oldest industries. The first bank was organized in 1782 before the adoption of our federal Constitution, and many of the banks that were organized in the 1800s are still in operation. Commercial banks are the most important type of financial institution in the nation in terms of aggregate assets. The growth of their assets and liabilities is presented in Figures 1-1 and 1-2. Total assets approximate \$3 trillion. In terms of employment, banking is one of our largest industries, with over 1.5 million employees.

FUNCTIONS OF COMMERCIAL BANKS

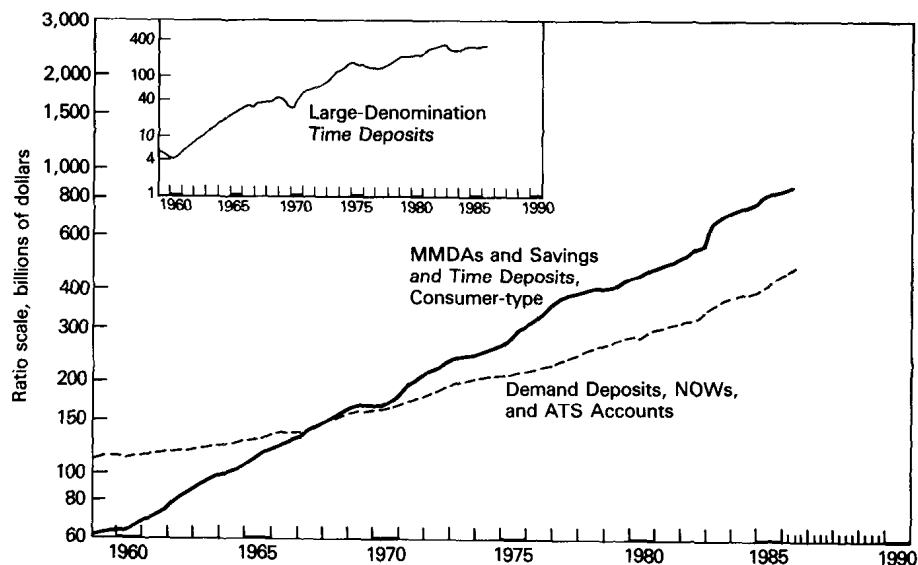
The business of banking is very broad and far-reaching; with the introduction of the one-bank holding company and the possibility of relaxation of some of the restrictions imposed on banking, the number and variety of services provided by commercial banks and their affiliates have expanded. Recent innovations in banking include the introduction of credit cards, accounting services for business firms, factoring, leasing, automated teller machines, discount brokerage, participation in the Eurodollar market, and lock box banking. The importance of commercial banks can best be illustrated by a brief explanation of their major functions.

FIGURE 1-1 Principal Assets of Commercial Banks (seasonally adjusted, quarterly averages)



SOURCE: Board of Governors of the Federal Reserve System, *Historical Chartbook*, 1986 (1987).

FIGURE 1-2 Principal Liabilities of Commercial Banks (seasonally adjusted, quarterly averages)



SOURCE: Board of Governors of the Federal Reserve System, *Historical Chartbook*, 1986 (1987).