Banking system

Finance

Banking Since time immemorial, banks have been a place where people deposit their money for safekeeping. This is process of depositing money for safekeeping is called ‘ retain and hold’ in banking. In essence, this means that banks have the responsibility of receiving customers’ money and keeping it for them for a given period after which they can withdraw when they need them. Therefore, banks act as safe stores for their customers. However, due to recent harsh economic environment, banks have been force to metamorphose and start engaging in various commercial activities to boost their profit gains. These activities include selling various insurance products, forming societies, and investment platforms for their customers. This is called ‘ buy and sell’ in banking. Banks are literally buying and selling products to consumers as a vender would do.

Profit maximization is one of the major core objectives of shareholders for establishing businesses. Therefore, as businesses, banks are out to make profits. Leverage refers to a process by which banks acquire assets using borrowed money and uses these assets to make more money hence enabling them to buy more assets than they previously had. This money is a profit to the bank and shareholders who have invested their funds in form capital in the bank. However, this process involves many risks and in some cases the assets acquired fail to generate more money than the initially anticipated hence resulting into the bank making losses. Either shareholders invest in banks expecting to get returns on their on their investment. However, banks also need this money to keep growing in order to increase their profits margins. Because of this, they are force to acquire more assets from other sources to enable them maximize shareholder profits. This process of leverage is therefore only effective if profits are made.

Banks request for securities when they are making loan advancements to their borrowers. The bank then holds this asset during the period covered by the loan for the purpose of security in case the borrower defaults in payment. If a customer defaults in paying back the loan and the accumulated interest, then it can dispose the security to recover the loan and interest. Therefore, securitization is the mechanism through which banks and other financial institutions pool together different types of debts owed to them, then repackage them, and finally sell them as securities like bonds and CMOs to different investors maximize their gains These institutions engage in these activities to maximize their gains and increase their overall liquidity. The principal and interest received from the underlying securities is then used to pay these investors on a regular basis.

Because the process of asset securitisation was seen as lucrative, convenient, profitable, and friendly to banks, many banks used this technique in the period 2008-2010 to increase their profits and liquidity levels. Some even borrowed from other banks to advance more loans to create securities. Because of the increased liquidity, many banks started lending more and more to borrowers consequently resulting to decrease in the level of interest rates. Either due to decreased interest rates, the number of borrowers increased tremendously because banks had high liquidity, they were willing or ready to lend to borrowers so that they would create securities.

1Thus, because of this, there was destabilisation of the financial market in the United States, which brought many banks to their knees. Therefore, too much lending proved to be less profitable to banks than they had initially thought. However, through securitization, using poor credit ratings (Caa/CCC

& below) for securitized assets, they were valued lowly hence making their marketability impossible and hence this helped control the liquidity of banks, which led to increased interest in the thus bringing stability for banks (Michael, 2009).

Bibliography

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