Essence of banking

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Abstract

Financial systems perform the essential economic function of channeling funds from units who have saved surplus funds to units who have a shortage of funds[1]. The units who have saved can lend funds: they are known as lender-savers. The units with a shortage of funds must borrow funds to finance their spending: they are the borrower-spenders.

In direct finance, borrower-spenders borrow funds directly from lenders in the financial markets by selling them securities. In indirect finance, a financial intermediary stands between the lender-savers and the borrower-spenders: the intermediary helps to transfer funds from one to the other.

Another important function of a financial system is the monetary function. The introduction of money into the economy enables savers and spenders to separate the act of sale from the act of purchase and allows them to overcome the main problem of barter, which is the 'double coincidence of wants' (each of the two parties involved in a transaction has to want simultaneously the good the other party is offering to exchange).

From a structural point of view, a financial system can be seen in terms of the entities that compose the system. A financial system comprises financial markets, securities and financial intermediaries.

Financial markets[2] are markets in which funds are moved from people who have an excess of available funds (and lack of investment opportunities) to people who have investment opportunities (and lack of funds).

Keywords: financial system, banking, financial market.

Introduction

In essence, banks are straightforward institutions: they take existing deposits (and loans to a small degree) and loan these funds, and, at the same time, make new loans and create new deposits (new money). However, while their basic function may be simple, the risks they assume are not, and this makes them complex.

Private sector banks play a significant role in the financial system and the real economy. They intermediate between all sectors of the economy and other financial intermediaries and institutions, and some of them provide the payments system, which most of us use every day.

Banks are unique in that their liabilities, bank notes and coins. Banks are able to create additional money when required by individuals, businesses and government (with the assistance of the central bank). This unique feature, plus their balance sheet structure, places banks in a unique position in another way: they are inherently unstable, and therefore require robust regulation and supervision.

<?> Faure AP (2005) "The financial system", Cape Town: Quon Institute (Pty) Limited.

2 Mishkin Fs & Eakins SG (2000) " Financial markets & Institutions", Reading, Massachusetts: Addison Wesley Longman, Inc.

Banks are innovative, largely a function of intense competition, and they are therefore at the forefront of new developments, not only in banking but also in the wider financial markets. This makes regulation and supervision complex.

An analysis of the effects associated with commercial banks' expansion into the securities business, particularly the underwriting of corporate securities, should consider why commercial banks exist in the first place.

Bank financing tends to be more expensive than public financing, thus explaining why firms tend to avoid the former type of funding. Moreover, some firms may also avoid bank funding to avert the additional scrutiny that usually comes with it. Because of this, firms with a higher reputation (usually larger firms) tend to raise funding directly in capital markets, while smaller and younger firms tend to rely on banks.

The banking industry recognizes that an institution need not engage in business in a manner that unnecessarily imposes risk upon it; nor should it absorb risk that can be efficiently transferred to other participants. Rather, it should only manage risks at the firm level that are more efficiently managed there than by the market itself or by their owners in their own portfolios. In short, it should accept only those risks that are uniquely a part of the bank's array of services.

Essence of banking

Financial systems

Financial systems perform the essential economic function of channeling funds from units who have saved surplus funds to units who have a shortage of funds[3]. The units who have saved can lend funds: they are known as lender-savers. The units with a shortage of funds must borrow funds to finance their spending: they are the borrower-spenders. The most important lender-savers are usually households; while the typical borrower-spenders are firms and the government.

The channeling of funds from savers to spenders is very important for two reasons:

• First, lender-savers (with excess of available funds) do not frequently have profitable investment opportunities, while borrower-spenders have investment opportunities but lack of funds.

• Second, even for purposes other than investment opportunities in businesses, borrower-spenders may want to invest in excess of their current income or to adjust the composition of their wealth (reconciliation of the preferences for current versus future consumption).

In direct finance, borrower-spenders borrow funds directly from lenders in the financial markets by selling them securities. In indirect finance, a financial intermediary stands between the lender-savers and the borrower-spenders: the intermediary helps to transfer funds from one to the other. This suggests that financial markets and intermediaries are alternatives that perform more or less the same function but in different ways (and perhaps with different degrees of success). Note, however, that the process of indirect finance, known as financial intermediation, is the most important way of transferring funds from lenders to borrowers.

[3] Faure AP (2005) "The financial system", Cape Town: Quon Institute (Pty) Limited.

Another important function of a financial system is the monetary function. The introduction of money into the economy enables savers and spenders to separate the act of sale from the act of purchase and allows them to overcome the main problem of barter, which is the 'double coincidence of wants' (each of the two parties involved in a transaction has to want simultaneously the good the other party is offering to exchange). The financial system provides a variety of payment mechanisms e.g. debit cards and credit cards to enable one party to pay another.

Financial systems also provide mechanisms for risk to be transferred. For example insurance contracts allow a party such as a firm or household to transfer the risk of loss of wealth due to theft or fire to another party such as an insurance company. The firm or household will pay a fee (insurance premium) for this transfer.

From a structural point of view a financial system can be seen in terms of the entities that compose the system. A financial system comprises financial markets, securities and financial intermediaries.

Financial markets[4] are markets in which funds are moved from people who have an excess of available funds (and lack of investment opportunities) to people who have investment opportunities (and lack of funds). They also have direct effects on personal wealth, and the behaviors of businesses and consumers. Therefore, they contribute to increase the production and the efficiency in the overall economy.

Financial markets (such as bond and stock markets) are markets in which securities are traded.

Securities (also called financial instruments) are financial claims on the issuer's future income or assets. They represent financial liabilities for the individual or firm that sells them (borrower or issuer of the financial claim) in return for money and financial assets for the buyer (lender or investor in the financial claim). By definition, therefore, the sum of financial assets in existence will exactly equal the sum of liabilities.

Governments and corporations raise funds to finance their activities by issuing debt instruments (bonds) and equity instruments (shares, known as stocks). Bonds are securities that promise to make periodic payments of a sum of money for a specified period of time. Stocks are securities that represent a share of ownership in the firm.

Financial intermediaries are economic agents who specialize in the activities of buying and selling (at the same time) financial contracts (loans and deposits) and securities (bonds and stocks). Note that financial securities are easily marketable, while financial contracts cannot be easily sold (marketed). Banks form the largest financial institution in our economy. They accept deposits (loans by individuals or firms to banks) and make loans (sums of money lent by banks to individuals or firms): therefore, they borrow deposits from people who have saved and in turn make loans to others. In recent years, other financial intermediaries, such as mutual funds, pension funds, insurance companies and investment banks, have been growing at the expense of banks.

Financial system is essentially concerned with borrowing and lending and has six parts or elements (Figure 1)[5]:

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[4] Mishkin Fs & Eakins SG (2000) " Financial markets & Institutions", Reading, Massachusetts: Addison Wesley Longman, Inc.

[5] M. Buckle & E. Baccalli (2008) " Principles of banking & finance", University of London, p.16-24.

First: lenders (surplus economic units) and borrowers (deficit economic units), i.e. the non- financial-intermediary economic units that undertake lending and borrowing. They may also be called the ultimate lenders and borrowers (to differentiate them from the financial intermediaries who do both). Lenders try and earn the maximum on their surplus money and borrowers try and pay the minimum for money borrowed.
Second: financial intermediaries, which intermediate the lending and borrowing process; they interpose themselves between the ultimate lenders and borrowers and endeavor to maximize profits from the differential between what they pay for liabilities (borrowings) and earn on assets (overwhelmingly loans). In the case of the banks this is called the bank margin. Obviously, they endeavor to pay the least on deposits and earn the most on loans. (this is why you must be on your guard when they make you an offer for your money or when they want to lend to you.)
Third: financial instruments, which are created to satisfy the financial requirements of the various participants. These instruments may be marketable (e.g. treasury bills) or non-marketable (e.g. a utilized bank overdraft facility).
Fourth: the creation of money when demanded. As you know banks (collectively) have the unique ability to create their own deposits (= money) because we the public generally accept their deposits as a means of payment.
Fifth: financial markets, i.e. the institutional arrangements and conventions that exist for the issue and trading (dealing) of the financial instruments.
Sixth: price discovery, i.e. the price of shares and the price of debt (the rate of interest) are "discovered", i.e. made and determined, in the financial markets. Prices have an allocation of funds function.

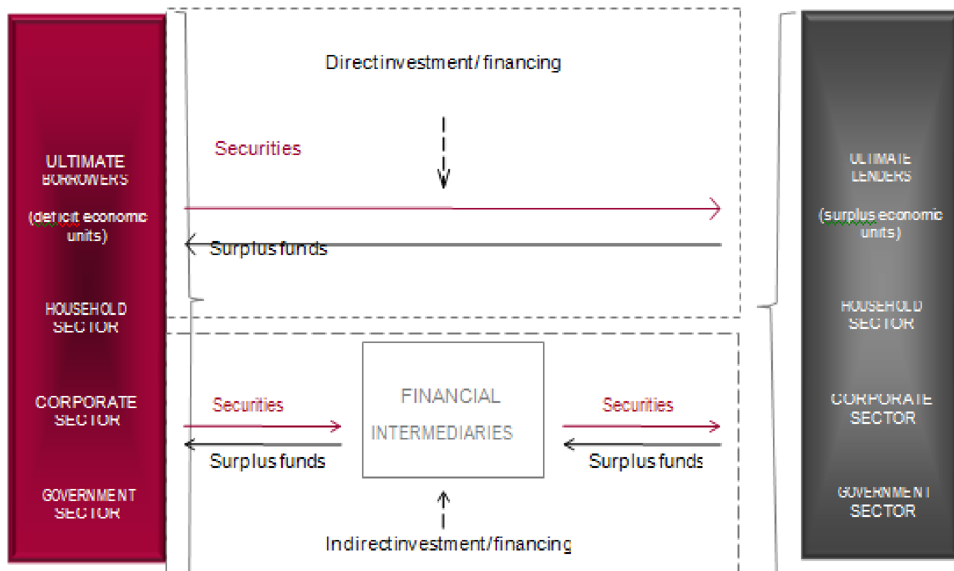

Figure 1: Financial systemSource: AP Faure (2013) "Bond Market: An Introduction", 1st edition, Quoin Institute (Pty) Limited & bookboon.com, p: 9.

Lenders and borrowers

The first element is lenders and borrowers. As seen in Figure 1, they can be categorized into the four groups or sectors of the economy:
Household sector (= individuals).
Corporate sector (= companies – private and government owned).
Government sector = all levels of government – local, provincial, central).
Foreign sector (= any foreign entity – corporate sector, financial intermediaries such as retirement funds).
The members of these sectors may be either lenders or borrowers or both at the same time. For example, a member of the household sector may have a mortgage bond (= borrower by the issue of a non- marketable debt instrument) and at the same time hold a balance on your accounts at the bank (= a lender; a holder of money).

Financial intermediaries

The second element is financial intermediaries. As seen in Figure 1, lending and borrowing takes place either directly between ultimate lenders and borrowers [e.g. when an individual buys a share (also called equity or stock) issued by a company], or indirectly via financial intermediaries. Financial intermediaries essentially solve the differences (or conflicts) that exist between ultimate lenders and borrowers in terms of their requirements: size, risk, return, term of loan, etc.
An example: your friend Johnny (a member of household sector) has LCC[2] 10 000 he would like to lend out (= invest) for 30 days at low risk. You (a member of household sector) would like to borrow LCC 20 000 for 365 days to buy a car. You don't mind who you borrow from, because you represent the risk, not the lender. Your and Johnny's requirements don't match at all; direct financing won't work. He places his LCC 10 000 on deposit with a prime bank for 30 days and you borrow LCC 20 000 from the bank for 365 days. You and Johnny are both in high spirits; the bank satisfied your different requirements.
Financial intermediaries exist not only because of the divergence of requirements of lenders and borrowers, but for the specialized services they provide, such as insurance policies (insurance companies), retirement fund products (retirement funds), investment products (securities unit trusts, exchange traded funds), overdraft and deposit facilities (banks), and so on. The banks also provide a payments system; the system we don't see but rely much on. The central bank provides an interbank settlement system. Note that the non- deposit intermediaries may also be seen as investment vehicles. Their products (= their liabilities), which can be called participation interests (PIs), are designed as investments for the household sector (and in some cases other financial intermediaries).

Financial instruments

The third element is financial instruments. They are also called securities; borrowers issue securities. They are therefore evidences of debt or shares. They also represent

claims on the issuers / borrowers.
Ultimate lenders exchange money (deposits) for securities and ultimate borrowers exchange (issue new) securities for money. Financial intermediaries issue their own securities (e.g. deposits) and hold the securities of the ultimate borrowers (e.g. treasury bills). As you know, the banks have a special and unique role in this market for money in that they are able to create money (bank deposits) by making new loans (buying new securities).
Securities offer a return that is fixed (fixed-interest debt) or variable (variable-rate debt and share dividends). The capital amount of shares and debt is paid back after a period (bonds and preference shares) or not ever (perpetual bonds and shares).
There are two categories of financial instruments:
Debt (and deposits);
Shares;
The instruments of debt and shares and their issuers are as follows:
Non-marketable debt (NMD) securities
Examples: overdraft loan from a bank; mortgage loan from a bank. the corporate sector issues:
Share securities (marketable = listed & non-marketable = non-listed)
Ordinary shares (aka common shares).
Preference shares (aka preferred shares).
Debt securities
Non-marketable debt (NMD).
Marketable debt (MD)
Examples: corporate bonds, commercial paper (CP), bankers' acceptances (BAs), promissory notes (PNs).
The government sector issues:
Marketable debt (MD) securities
Treasury bills
Bonds
The foreign sector issues (into the local markets):
Foreign share securities (inward listings).
Foreign debt securities (inward listings).
The deposit financial intermediaries (central and private sector banks) issue:
Deposit securities
Central bank
Non-negotiable certificates of deposit (NNCDs).
Notes and coins.
Central bank securities.
Private sector banks
Non-negotiable certificates of deposit (NNCDs).
Negotiable certificates of deposit (NCDs).
Loans (mainly from the central bank).
The quasi-financial intermediaries issue:
Debt securities
Non-marketable debt (NMD)

Example: utilized overdraft facility.
Marketable debt (MD)
Examples: bonds, commercial paper (CP)
As we have indicated, it is rare that the individual invests in these financial instruments (the exceptions are bank deposits in the form of NNCDs and shares). Rather, they invest in these ultimate financial instruments via the investment vehicles, by buying their PIs.

Financial markets

The fourth element of the f inancial system is financial markets. Financial markets are categorized according to the securities issued by ultimate borrowers and financial intermediaries. It was noted above that financial securities are either marketable or non-marketable. Examples are non-negotiable certificates of deposit (NNCDs) (= an ordinary deposit receipt) and negotiable certificates of deposit (NCDs) issued by the private sector banks.
There are two market types or forms: primary market and secondary market. All securities are issued in their primary markets and the marketable ones are traded in the secondary markets. In the primary market the issuer receives the money paid by the lender/buyer. In the secondary market the seller receives the money paid by the buyer.
There are a number of markets for financial instruments: the market for life policies (a primary market only), the market for PIs (also called units) of securities unit trusts (a primary market and a partial secondary market: the units are saleable to the issuer), the market for PIs in retirement funds (strictly a primary market), the deposit market (primary market for NNCDs and a secondary market for NCDs), the bond market (secondary market), and so on.
The money market should be defined as the short-term debt market (STDM = marketable and non-marketable debt), while the bond market is the marketable arm of the long-term debt market (LTDM).
The money market (STDM) and the LTDM together make up the debt market (also known as the interest- bearing market and the fixed-interest market). The terms interest-bearing and fixed-interest oppose the debt market from the share market because the returns on shares are dividends and dividends are not fixed – they depend on the performance of companies. The LTDM and the share market is called the capital market.
The foreign exchange market is not a financial market, because lending and borrowing do not take place in this market. Rather, it is a conduit for foreign investors into local financial markets and for local investors into foreign financial markets.
In addition to these cash or spot markets [where the settlement of deals takes place a few days after transaction date (T+0)] we have the so-called derivative markets. They are comprised of instruments (forwards, futures, swaps, options and "others" such as weather derivatives) that are derived from and get their value from the spot financial markets. Whereas cash markets settle as soon as possible, derivative markets settle at some stage in the future.
Secondary markets are either over-the-counter (OTC), also called "informal markets" (such as the foreign exchange and the money markets) because there is no exchange

involved, or exchange-driven (or formal) markets, such as the share (or stock) exchange. The financial markets do not intermediate the financial lending and borrowing process as do financial intermediaries such as banks; they merely facilitate the primary and secondary markets.

Money creation

The fifth element is creation of money. As this is covered in detail later, we will not give it much attention here. Here follows a brief summary: when banks make new loans / provide new credit (= buy NMD, MD and shares), they create NBPS deposits (= money). The referee in this game is the central bank which controls the growth rate in money creation (= new bank deposits resulting from new bank loans) by means that differ from country to country (which are elucidated later). The principal method is the interest rate on banks' loans (= bank assets) via the central bank's KIR interest rate, which influences the cost of bank liabilities (i.e. via the bank margin).

Price discovery

The sixth element is price discovery. Primary and secondary markets are important for a number of reasons, the most important of which is price discovery, i.e. the establishment of interest rates for various terms and the prices of shares. Interest rates, as we will see, have an important role to play in the pricing of all assets. The central bank plays a significant role in the establishment of interest rates. These significant issues are addressed lat**Allied participants on the financial system**

From the above discussion it will be evident that there are a number of allied participants on the financial system. By this we mean participants other than the principals (those who have financial liabilities or assets or both). As we now know, the principals are:

Lenders.

Borrowers.

Financial intermediaries.

The allied participants, who play a major role in terms of facilitating the lending and borrowing process (the primary market) and the secondary markets are the financial exchanges and their members. Also we need to mention the fund managers, who are actively involved in sophisticated financial market research and therefore play a major role price discovery, and the regulators of the financial markets. Thus the allied non-principal participants in the financial markets are:

Financial exchanges.

Broker-dealers.

Fund managers.

Regulators.

Conclusions

Banks are quite important to the economy and are involved in such economic activities as issuing money, settling payments, credit intermediation, maturity transformation

and money creation in the form of fractional reserve banking.

To make money, banks use deposits and whole sale deposits, share equity and fees and interest from debt, loans and consumer lending, such as credit cards and bank fees.

In addition to fees and loans, banks are also involved in various other types of lending and operations including, buy/hold securities, non-interest income, insurance and leasing and payment treasury services.

The banking sector is considered to be an important source of financing for most businesses. The common assumption, which underpins much of the financial performance research and discussion, is that increasing financial performance will lead to improved functions and activities of the organizations. The subject of financial performance and research into its measurement is well advanced within finance and management fields. It can be argued that there are three principal factors to improve financial performance for financial institutions; the institution size, its asset management, and the operational efficiency. To date, there have been published studies to explore the impact of these factors on the financial performance, especially the commercial banks.

Services Organizations in general and financial services in particular are considered to be the key factor for growth and success of projects in both industrial and developing countries. However, the commercial banks take pride in offering customers a full range of superior international banking services inside and outside of Kosovo. The major objective for Kosovo commercial banks is to concentrate on trade services and cash management. In fact, Kosovo has always had a nation-wide development policy that was careful to achieve a wider geographic distribution of investment to ensure that all the different regions in Kosovo could share the benefits and any gap in the standard of living could be narrowed.

This study examined these predictors impact on the financial performance of Kosovo commercial banks. Finally, the study provides bank managers with understanding of activities that would enhance their banks financial performances. The results of this study imply that it might be necessary for a bank management to take all the required decisions to enhance the financial positions of the bank.

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