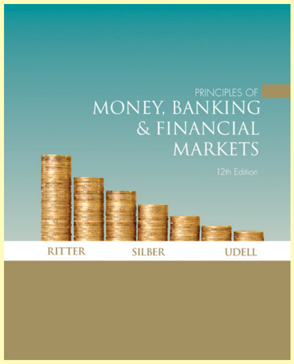
Chapter 13

Nondepository Financial Institutions



Learning Objectives

- Understand thee broad range and function of nondepository financial institutions
- Describe the tools of insurance companies
- Define the types and obligations of pension funds
- Distinguish finance companies and alternative financing institutions such as venture capital funds, hedge funds, and mezzanine debt funds

Life Insurance Companies

- The first life insurance company in the U.S. was established before the Revolutionary War and is still in existence
- Structured as either stock companies (owned and controlled by shareholders) or mutual associations (ownership and control rests with the policyholders)
- Supervised and regulated almost entirely by the states in which they operate

Life Insurance Companies (Cont.)

- Regulation of life insurance companies includes:
  - Sales practices
  - Premium rates
  - Allowable investments
- Usually overseen by a state insurance commissioner, who might also be the state banking commissioner

Life Insurance Companies (Cont.)

- **Types of life insurance policies:**
  - **Whole Life Insurance**
    - Constant premium that is paid through entire life of policy
    - Build up cash reserves or savings which can be withdrawn as borrowing or outright by canceling the policy
    - Savings component pays a money market rate of interest that changes with market conditions

Life Insurance Companies (Cont.)

- **Types of life insurance policies: (Cont.)**
  - **Term Life Insurance**
    - Pure insurance with no cash reserve or savings element
    - Premiums are relatively low at first but increase with the age of the insured individual
  - **Universal (variable) Life**
    - Variation on whole life policy
    - "Unbundle" the term insurance and tax-deferred savings component
    - Owner can elect how to allocate the savings component among a menu of investment options, thereby potentially earning above money market rates

Life Insurance Companies (Cont.)

- Based on actuarial tables, life insurance companies have ability to predict cash flow
- Typically insurance companies use excess funds to buy long-term corporate bonds and commercial mortgages
  - Higher yields
  - Unlikely of having to sell prior to maturity
- However, lately they have branched out into riskier ventures such as common stock and real estate

Pension Funds

- Individuals need pension plans to supplement Social Security benefits
- Most **pension fund** assets are in employer-sponsored plans
- **Defined Benefit Plan**
  - Retirement benefits are defined by the plan
  - Employer contributions are adjusted to meet the benefits and insure the plan is **fully funded**—enough funds to meet future obligations

Pension Funds (Cont.)

- **Defined Benefit Plan (Cont.)**
  - **Vesting**—retirement benefits remain with the employee if they leave the firm and is based on length of employment
  - **Employee Retirement Income Security Act (ERISA)**—establishes minimum reporting, disclosure, vesting, funding and investment standards to safeguard employee pension rights
  - **Pension Benefit Guaranty Corporation**—guarantees some benefits in defined benefit plans if company is unable to meet its accrued pension liabilities

Pension Funds (Cont.)

- **Defined Contribution Plan**
  - Contributions are defined by the plan
  - Contribution may be made by employees or employers or a combination of the two
  - Employee contributions are tax deferred—taxes payable when funds are withdrawn
  - Benefits depend on the performance of the assets in the plan
  - Avoids the problems of vesting and funding
  - Individual employee has the ability to choose the assets in which to invest
  - Most common are **403(b) and 401(k)**

Pension Funds (Cont.)

- Defined contribution plans are the type favored by most employers, although some employers offer both plans
- In addition to employer-sponsored plans, some individuals are given tax incentives to set up their own pension plans
  - **Keogh Plans**—self-employed individuals
  - **Individual Retirement Accounts (IRAs)**—working people who are not covered by company-sponsored pension plans

Property and Casualty Insurance Companies

- Because of uncertainty of liability in this type of insurance, unable to plan their future cash requirements
- Tend to invest in tax-free municipal bonds and liquid short-term securities
  - Lower yields
  - Highly liquid
- Regulated and supervised by the states in which they operate

Property and Casualty Insurance Companies (Cont.)

- State insurance commissions set ranges for rates, enforce operating standards, and exercise overall supervision over company policies
- Little federal involvement in regulating these companies

Mutual Funds

- Money Market Mutual funds have been prominent on the American financial scene since the 1970s
- However, stock market mutual funds (**Mutual Funds**) have been in existence since the 1950s.
- A mutual fund pools the funds of many people and managers invest the money in a diversified portfolio of securities to achieve some stated objective

Mutual Funds (Cont.)

- **Open-end Mutual Fund**
  - Sell redeemable shares in the fund to the general public
  - Shares represent a proportionate ownership in a portfolio held by the fund
  - Shareholder can go directly to fund and buy additional shares or redeem shares at their **net asset value (NAV)**
  - **No-load Funds**--Sold directly to public at the current NVA
  - **Load Funds**—Sold through brokers and buyer pays a sales commission

Mutual Funds (Cont.)

- **Closed-end Investment Companies**
  - Issue a limited number of shares
  - Mutual fund company does not redeem their own shares on demand
  - Shares of closed-end funds are traded in the stock market through a third party

Mutual Funds (Cont.)

- Mutual funds are regulated by the Securities and Exchange Commission (SEC)
- Primary objective of regulation is the enforcement of reporting and disclosure requirements to protect the investor
- Many investors are attracted to **families** of mutual funds
  - Number of mutual funds operated under one management umbrella
  - Investors can easily transfer money among funds within the family

Finance Companies

- **Consumer Finance Companies**
  - Make consumer loans
  - **Specialty Finance Companies**—specialize in credit card financing
- **Commercial finance Companies**
  - Make commercial loans usually on a secured (collateralized) basis
  - Loans not as risky as consumer loans
- Since lending is short-term, these companies borrow substantial amounts in commercial paper market

Finance Companies (Cont.)

- Historically finance companies have played an important role in financing growing undercapitalized companies
- Commercial finance companies originated the concept of **leveraged buyout (LBOs)** which relies heavily on debt to pay for acquisition of a company
- **Captive Finance Companies**—Finance purchase of commercial and retail oriented businesses such as General Motors products (GMAC)

Securities Brokers and Dealers and Investment Banks

- These financial institutions play a crucial role in the distribution and trading of huge amounts of securities
- **Investment banks**
  - Sell and distribute new stocks and bonds directly from issuing corporations to original purchasers
  - **League Tables** rank investment banks by the volume of securities they underwrite
  - **Underwriting** is typically conducted through a **syndicate** which includes many investment banks and brokerage firms

Securities Brokers and Dealers and Investment Banks (Cont.)

- **Investment banks (Cont.)**
  - Investment banks derive a substantial amount of income from offering advice to firms involved in mergers and acquisitions
    - What price one firm should pay for another
    - How the transaction should be structured
    - Provide strategic advice in **hostile takeovers**—when one firm seeks to acquire another against the other's wishes

Securities Brokers and Dealers and Investment Banks (Cont.)

- **Brokers and Dealers**
  - Involved in the secondary market, trading "used" or already outstanding securities
  - Brokers match buyers and sellers and earn a commission
  - Dealers commit their own capital in the buying and selling of securities and hope to make profit on the transaction

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Securities Brokers and Dealers and Investment Banks (Cont.)

- **Brokers and Dealers (Cont.)**
  - Many of the nationwide stock exchange firms act as investment bankers, dealers, and brokers
  - A number of large stock exchange firms have branched out to provide new types of financial services previously out of their operating charter
  - Commercial banks, investment banks, and broker dealers have now combined under single holding company umbrellas

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Venture Capital Funds, Mezzanine Debt Funds, and Hedge Funds

- Venture capital funds, mezzanine debt funds, and hedge funds are usually not available to public investors and not registered with SEC
- Funding comes from wealthy individuals or other financial institutions, possibly sponsored by brokerage firms and banks
- Both venture capital funds and mezzanine debt funds provide an important source of funding to small and midsize companies
- Financing by both venture and mezzanine funds is **non-traded** and held until maturity

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Venture Capital Funds, Mezzanine Debt Funds, and Hedge Funds (Cont.)

- **Venture Capital Funds**
  - Invest funds in **start-up companies**
  - Traditional bank financing for these firms in the early stage of growth would be very limited
  - The Venture Capital Fund receives a substantial equity stake in the firm
  - Although many start-up companies will fail, significant profit on those that are successful
  - Receives profits when it takes the successful company public in an **initial public offering (IPO)**.

Venture Capital Funds, Mezzanine Debt Funds, and Hedge Funds (Cont.)

- **Mezzanine Debt Funds**
  - Provide debt funds to small and midsize companies
  - Issue **convertible debt and subordinated debt**
  - Sometimes simply invest in a combination of high-yielding debt and equity issued by the same company
  - Used to provide long-term funds, sometimes part of a management-buyout financing package

Banks Versus Nondepository Institutions

- Many nondepository institutions offer services that compete directly with banks
- Traditionally many of the different markets were segmented, however, today they often compete for the same business
- The **Gramm-Leach-Bliley Act of 1999** allowed the creation of **financial holding companies (FHCs)** that can own commercial banks, investment banks, and insurance underwriters

Banks Versus Nondepository Institutions (Cont.)

- The creation of FHCs brings the United States much closer to the **universal banking** regulatory model adopted by the European Union