Chapter 13
Nondepository Financial Institutions

Learning Objectives

• Understand the 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    • Build up cash reserves or savings which can be withdrawn as borrowing or outright by canceling the policy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

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

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
**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.