

# 1 Non-Deposit Taking Institutions (N-DI)

## 1.1 Insurance Companies

Insurance companies compete strongly with banks and trusts for savings. Funds are acquired in the form of premium payments. Once acquired, the funds are invested in government securities, real estate and mortgages. From these investment revenues, insurance companies earn profits to pay shareholders' dividends and cover their operation costs.

Prior to the financial deregulation, DIs were forbidden from selling insurance.

### 1.1.1 Life Insurance Companies (L. Ins. Co)

Presently, U.S. citizens spend annually an approximate of 2 percent of their disposable income on life insurance premiums. In the U.S., the first life insurance company was established in 1759 and named the 'Presbyterian Ministers Fund'.

The activities of the Life Insurance Company are,

1. Selling individual or group life insurance contracts
2. Manage pension plans
3. Sell life annuity contracts
4. Plan RRSP and RRIF

Life Insurance Companies ownership

There are two types of life insurance companies, the mutual type' company and the joint stock type' company. Regardless of type, the governing board of directors is elected annually at a general meeting.

**Mutual Type Life Insurance Company**

The company is owned by its policyholders. Each policyholder has one vote to elect the governing board of directors. The ownership system is similar to the credit unions.

**Joint Stock Type Life Insurance Company**

The company is owned by its shareholders. The size of shares held determines the number of votes.

## 1.1.2 Property and Casualty Insurance Companies (P&C Ins)

Different P&C insurance companies could be classified by type of business. There are,

- Automobile insurance
- Personal property insurance (e.g., home ownership)
- Commercial property insurance (e.g., fire, theft)
- Commercial liability (e.g., business operations, hazard products)
- Marine insurance (e.g., water transportation of property)
- Reinsurance (i.e., selling insurance contracts to insurers for the purpose of exchanging insurance risk between insurance companies)

## 1.1.3 Proposition 103

### The California Revolt against P&C insurance premiums

In 1988, California voters passed ‘Proposition 103’. The proposition stipulates that auto insurance premiums should be reduced and should not vary with the geographical location of the policyholder. The proposition aimed to harmonize the rates across all counties. Auto insurance premiums were high for big cities’ drivers (Los Angeles and San Francisco) and relatively lower for small cities’ drivers. After the legislative passing of the proposition, several P&C insurance companies announced that they are pulling out of the California market.

#### Assignment:

Can you think of reasons motivating ‘Proposition 103’?

## 1.2 Trusts

A trust is an entity that results from an act (onerous or gratuitous contract, or will), whereby a person transfers property from his or her patrimony that he or she constitutes; the property is appropriated for a particular purpose, and a trustee undertakes to hold and administer it.

There are several types of trusts.

1. Amateur Athlete Trust  
The trust is created whereby the funds are received for the benefit of an athlete.
2. Deemed Trust

An institution such as a usufruct, a right of use or a substitution is deemed to be a trust. If it was created under a will, the trust is deemed to be a testamentary trust.

3. Employee Benefit Plan/Employee Trust

The employer remits contributions to the employee or to the former employee.

4. Investment Club

It is a bona fide trust if

- The majority of the members are individuals
- Members of the same family do not hold, at any time, more than 50 percent of the outstanding units if the club
- The bulk of the property consists of cash, shares, bonds or units of a unit trust
- The disposition of the property of the club gives rise to a capital gain or loss rather than to business income or a business loss.

5. Master Trust

If the trust makes an election to that effect in the return of its first taxation year and if it meets the following conditions

- It only undertakes the investment of funds
- It has never borrowed money
- It has never accepted deposits
- The only beneficiaries are trusts governed by a registered pension plan or a deferred profit sharing plan.

6. Mutual Fund Trust

It is a unit trust in which the holding of units and the transactions respecting them comply with the prescribed conditions governing the number of holders and the distribution and public trading of units.

7. Non-profit Organization / Religious Organization Trusts

This is a trust that include clubs, partnership or associations that are organized and operated exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit.

## 1.2.1 Trustee Pension Plans/Funds (TPP)

This financial institution provides income for retirees. Formally, it has no intermediation function because it is not an independent legal entity. It is a trust fund with trustees and managers accepting contributions from members and paying life annuities to beneficiaries. There are three different plans.

1. Public plans
2. Personal plans
3. Private plans

To alleviate the effects of the Great Depression, in the U.S. the ‘Old Age and Survivors Insurance Fund’ [also known as ‘Social Security’] was created in 1935 as a government managed pension plan to provide retirement income insurance. Participation in the fund by every worker in the U.S. is compulsory. Eligibility to withhold from the pension fund starts at the age of 62. In 1996, approximately 11.5 million Americans received pensions. The annual average pension payment is \$7,000.

Private plans are for specific groups (e.g., corporate or government employees). Corporate private plans are funded by

1. Guaranteed life insurance contract, or
2. Trusteeship (and hence the name Trustee Pension Plan TPP).

A TPP is managed by an insurance company or a trust company or at least by three individuals. Each can hold and manage the fund’s assets for the benefit of the plan members according to the specified rules outlined in the pension plan. TPPs invest a large portion of the funds in bonds and stocks. TPPs do not invest in real estate or mortgages. TPPs provides no loans to members. In 1993, TPP funds reached a \$311 billion in assets in Canada. In the U.S. pension plans assets are valued at \$3 trillion.

Regulators in the U.S.

State and local governments regulate public plans. In 1974, Congress passed the ‘Employee Retirement Income Security Act (ERISA)’ to regulate private plans. The act specified government regulatory agencies role in regulating private pension plans.

The act resulted in,

1. The ‘Department of Labor’ administers and protects employees’ pension plans
2. The ‘Internal Revenue Service (IRS)’ investigates and insures participation and funding
3. Created the ‘Pension Benefit Guaranty Corporation (PBGC)’ to insures private plans and to investigates plan terminations. Congress determines the premiums a private plan must pay to PBGC for insurance.

## 1.3 Finance Companies

During the first half of the 20<sup>th</sup> century, finance companies grew rapidly. For many years, they were the only financial institution (except credit unions) allowed to take goods security on items such as automobiles and home appliances when making personal loans. Given the higher risk of the loans given by finance companies, they demanded higher interest on personal loans. Finance companies are involved in the creation of debts with the funds used for purchasing specific goods and services at the corporate, wholesale or retail levels.

Finance companies are non-deposits taking institutions. They provide financing for businesses and consumers. Finance companies are specialized by industry/activity. They could be independently, government or captive owned. A captive owned finance company is a company owned by another company. In other words, the finance company assists its parent firm in extending consumer credit.

The finance companies activities are,

- 1) Financing (e.g., the auto industry)
- 2) Leasing (i.e., long-term equipment).

For the automobile industry, finance companies are the one a consumer deals with when purchasing an automobile. In the auto industry, examples for finance companies are General Motors Acceptance Corporation, General Electric Capital Corporation, Ford Motor Credit and Chrysler Financial Credit. The leasing activity could be for automobiles, air-crafts, construction materials or medical equipment.

Finance companies may issue credit cards, e.g., Discover card by Sears, Roebuck and Company.

### Regulations

There are no regulations for finance companies. The only act, which addresses these companies, is the ‘Small Loans Act of 1994’. Finance companies lack regulations but not monitoring. Usually, the captive company undertakes the monitoring process of a finance company. Finance companies are the least regulated financial institutions.

## 1.4 Investment Dealers

Independent until 1989, investment dealers are one of the old pillars of the financial system. In the U.S. they are called ‘Investment Banks’ or ‘Broker-Dealers Securities Firms’. In the U.K. they are called ‘Merchant Banks’.

Examples of prominent investment dealers in the U.S. are,

1. Goldman, Sachs & Company
2. Morgan Stanley
3. Merrill Lynch
4. Salomon Brothers
5. First Boston Corporation

The investment dealers’ activities are

1. Underwrite, sell, trade and take custody of securities
2. Provide investment and other financial advice to clients
3. Help issuers raise funds by selling debt, equity or derivative securities to investors.

Underwriting:

The underwriting process is the purchase of the entire new issue from the issuer and then re-sell it to the public

Investment dealers’ activities by area,

1. Investing and managing mutual funds and/or pension plans
2. Investment banking, i.e., underwriting/valuing/distributing new issues of debt, equity, derivative securities
3. Market making, i.e., maintaining a secondary market in an asset
4. Trading securities
5. Other service functions, e.g., custody, clearance, settlement’ services.

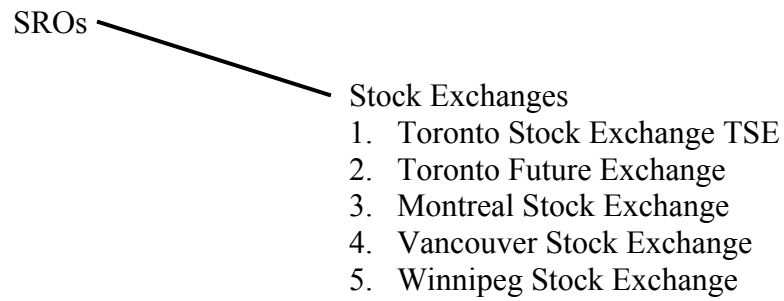
Regulations

1. Self-Regulatory Organizations (SROs)  
SROs are non-government institutions that have power over its members.

Investment Dealers Association (IDA)

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Each investment dealer must be member of the IDA and a member of at least one of the stock exchanges.

## 1.5 Mutual Funds (MF)

The first mutual fund can be traced back to Dundee, Scotland in 1873. In Canada, mutual funds appeared in 1932 but did not gain a wide support until mid 1970s. Nowadays, each pillar of the old structure offers MFs. They are largely sold to small investors.

During the 1970s, (exactly in 1975) interest rates ceiling on deposits at banks and thrift institutions spurred the growth of the MF market. Investment firms and brokerage firms began offering MMMF. It paid market-based interest rates by investing small sums gathered from many customers in short-term market instruments (Commercial paper and Treasury securities). It also did provide access through limited check-writing privileges. The volume of assets reached 1 trillion dollars in 1996.

A mutual fund is a firm that collects investment from a wide range of investors and uses these funds to purchase a portfolio of securities. Each investor owns a fraction of the entire portfolio. The mutual fund is a legal incorporation that is equity financed investment vehicle. A fund manager for the benefit of the equity investors (unit holders) administers the MF. The fund manager issues equity securities to the fund unit holder.

Think of a mutual fund as a box wherein every small investor deposits some cash. Now, a fund manager is chosen and manages the fund by buying in specific securities. Out of the profits the fund makes, each investor is paid a dividend.

Each fund must state the types of assets in which it will be investing and the philosophy of investment pursued by the fund manager.

Mutual funds are divided by type of assets,

1. Money Market Mutual Fund (MMMF)  
A MMMF invests in T-Bills, term deposits, provincial short-term promissory notes and commercial papers.
2. Long-Term Investment Mutual Fund  
The majority of existing MFs are of this type. It combines different assets and different fees' structures. If the MF is eligible, this type of MF is mostly used for RRSPs.

Non-Eligible MF for RRSP:

A mutual fund is non-eligible for RRSP if more than 20 percent of the book value of the RRSP is invested in foreign equities.

Many customers use a 'Sweep Account' to participate in the MMMF. A 'Sweep Account' is an account where the customer sets minimum and maximum thresholds. If the account balance is below the minimum set, then a transfer from the MMMF to the account is carried. If the account balance is above the maximum, then a transfer from the account to the MMMF is carried automatically.

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Mutual funds are structured as follows,

**Open-Ended Mutual Fund**

This is the most common fund that exists. This fund allows shares to be redeemed at any time at a price that is tied to the asset value of the fund. The purpose of this type of fund is to provide greater liquidity to the investors.

**Close-Ended Mutual Fund**

The fund is made of a fixed number of non-redeemable on demand shares. Initially, the shares are sold at an offering and are then traded in the over-the-counter market like a common stock. This type of funds provides greater returns.

In the U.S., the ‘Investment Company Act of 1940’ stipulated that mutual funds are to be regulated by the ‘Securities and Exchange Commission’.

## 1.6 Government Financial Agencies

### 1.6.1 United States

Government financial agencies can be classified by the main activity it offer as follows,

#### Mortgage Credit

The U.S. position on home ownership is best described by “Homeownership is a socially desirable good of high priority”. This belief spurred the creation of government financial agencies to help its citizens.

**Table 1: Mortgage Credit Government Financial Institutions**

	Other Name	Activity
Federal Housing Administration (1934)	FHA	Insures mortgages
Veterans Administration (1944)	VA	<ul style="list-style-type: none"><li>• Helps ex-service personal in obtaining mortgages (called GI loans).</li><li>• Allowed to make mortgage loans</li></ul>
Federal National Mortgage Association (FNMA)	Fannie Mae	All provide funds for mortgage market by selling bonds and using the proceeds to buy mortgages on the secondary market
Government National Mortgage Association (GNMA)	Ginnie Mae	
Federal Home Loan Mortgage Corporation (FHLMC)	Freddie Mac	

#### Agriculture Credit

The purpose of agriculture credit agencies is to provide easier access to credit aid for farmers.

A) The ‘Farmers Home Administration’

This agency is part of the Department of Agriculture.

B) The Farm Credit System

The system is a government organization with a board to manage the aid. The board is made of 13 members, 12 of whom are appointed by the President of the United States and one member is appointed by the Secretary of Agriculture. The system include the following organizations,

1. The ‘Federal Land Bank System’ that is compromised of 12 banks established geographically across the U.S. in 12 districts.
2. The ‘Production Credit System’
3. The ‘Banks for Co-operatives’.

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