

How Does the Banking System Work? (HA)

What do you notice when you enter a bank? Perhaps you pass an automated teller machine in the lobby. ATMs can dispense cash, accept deposits, and make transfers from one account to another. You may see desks and offices on the main floor. There are probably bank tellers behind a counter ready to assist you. Beyond the counter, there may be a large vault for storing money and other valuables.

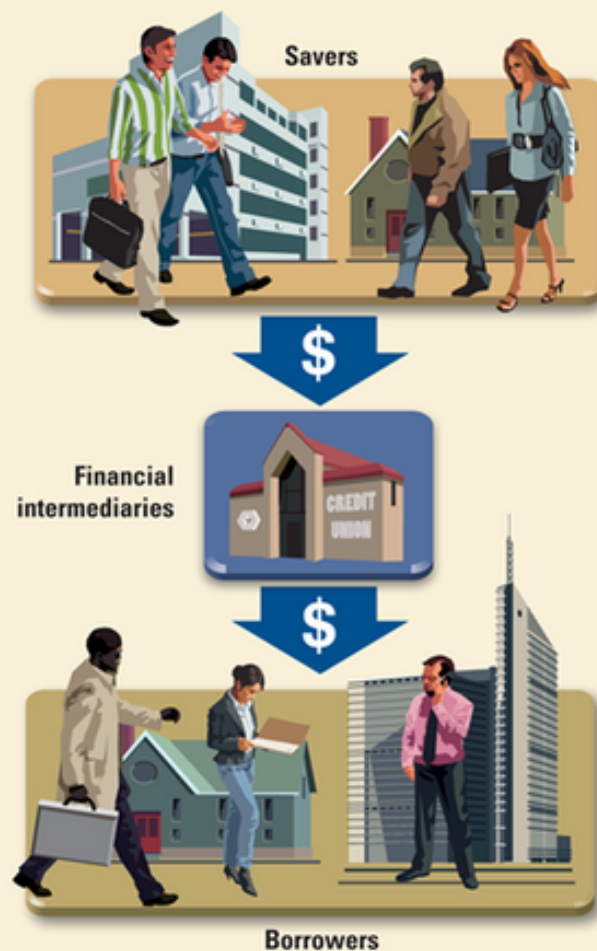
The process seems fairly straightforward. Money comes in. Money goes out. The bank keeps track of every penny. But what goes on behind the scenes? How does your bank fit into the whole banking system?

The Elements of the Banking System

Key Concept

Financial Intermediaries

A financial intermediary is a "middleman" that brings together savers who have surplus money to loan and borrowers who have a need for that money. Banks, credit unions, and savings and loan associations all act as financial intermediaries.



Banks are **financial institutions** [**financial institution: a firm that deals mainly with money, as opposed to goods and services; example include banks and stock brokerages**] —firms that deal mainly with money, as opposed to goods and services. Like all financial institutions, a bank must have a charter, or agreement, from the state or federal government that spells out how it will operate and how it will be regulated.

There are several kinds of banks, including commercial banks, savings and loans, mutual savings banks, and credit unions.

Historically commercial banks served business and industry. The others focused on consumers, encouraging them to embrace the idea of **saving** [**saving: setting aside a portion of income for use in the future**] —putting money aside for later use. Today the differences between the various types of banks have almost vanished. All banks work with businesses and consumers, and all offer the same basic kinds of services.

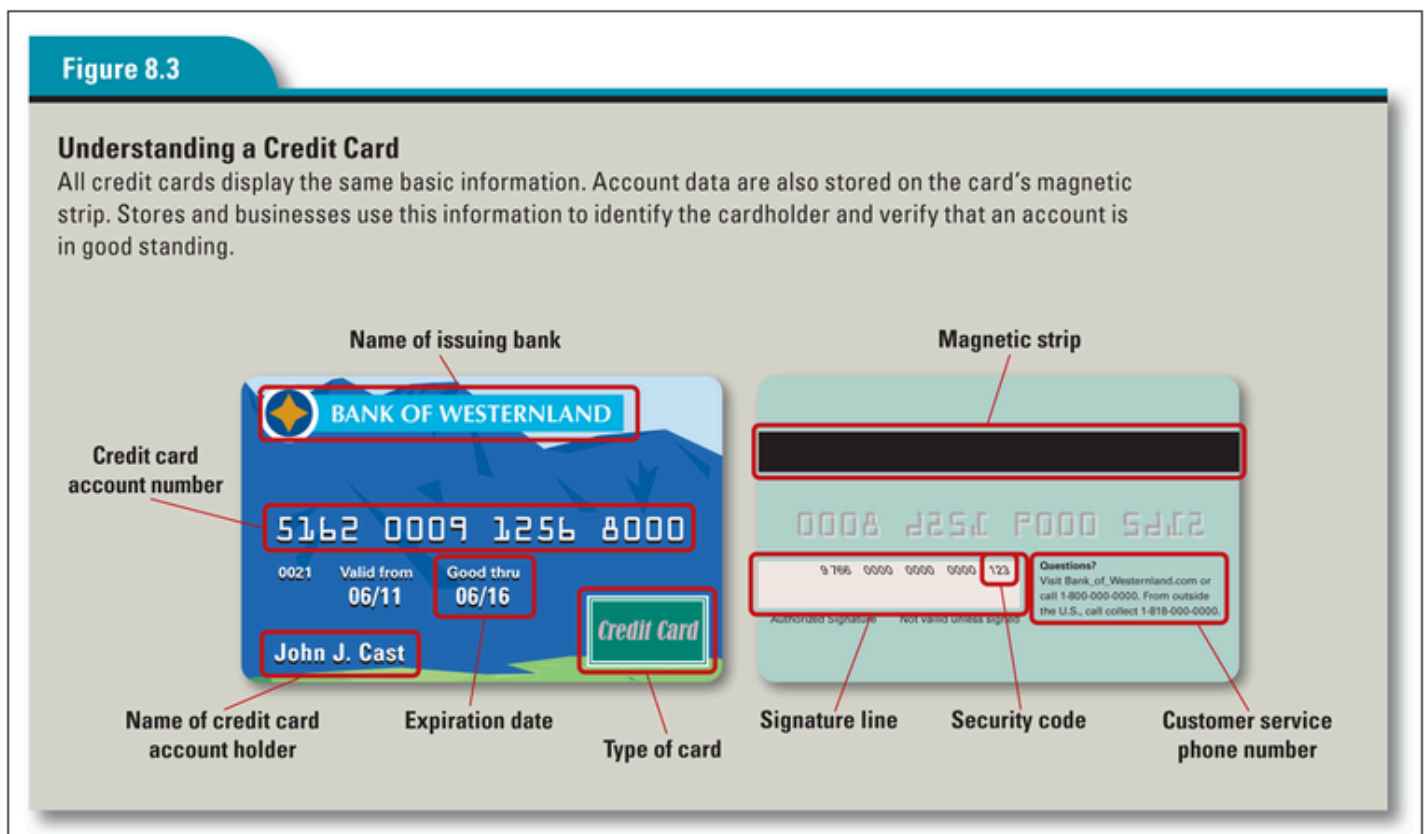
Banks Offer a Range of Services

Banks serve consumers in a variety of ways. They cash checks, issue credit cards, change foreign currency into dollars and vice versa, and provide safe-deposit boxes for storing valuables. Banks also offer the convenience of electronic banking through ATMs, debit cards, direct deposit of paychecks, and automatic payment of bills. Customers can use the Internet to monitor their accounts, pay bills, and transfer money from one account to another.

A bank's main function, however, is to serve as a financial intermediary [**financial intermediary: a business, such as a bank, that brings together savers (sellers) and borrowers (buyers) in financial markets**] —an institution that brings together sellers and buyers in financial markets. The sellers and buyers that banks bring together are savers and borrowers. Banks help transfer assets from one to the other. Specifically, banks receive deposits from savers and make loans to borrowers. These are the two main services that banks deliver.

Banks Receive Customers' Deposits

A time-tested way to save money is to deposit it in a bank. **Banks offer three kinds of deposits: checkable deposits, savings deposits, and time deposits.** Each bank has its own rules about when savers can withdraw deposited money. As a result, accounts vary in their **liquidity** [**liquidity: the ease with which assets can be converted into cash**], or the ease with which they can be converted into cash. They also vary in their return, or the amount of earnings they generate.



Checkable deposits. A checkable deposit is an amount of money placed in a checking account. Checkable deposits are highly liquid. That is, they can easily and quickly be converted into cash. You can withdraw money deposited in a checking account on demand, any time you wish. This withdrawal once called for writing a check, but today most checking accounts can be accessed electronically using the Internet, a debit card, or an ATM.

Money in a checking account, however, earns little or no interest. **Interest [interest: a periodic payment for the use of borrowed funds; interest is paid on a loan]** is money paid periodically in return for the use of borrowed funds. Checkable deposits, then, provide safety and liquidity, but not much in the way of earnings.

Savings deposits. Money deposited in a savings account earns more interest than checkable deposits, although the return is still low. Funds can be held for any length of time, and the entire deposited amount can be withdrawn on demand.

Savings deposits are only slightly less liquid than checkable deposits. Savers usually make withdrawals from savings accounts by using ATMs or by presenting withdrawal slips to bank tellers.

Time deposits. Savers who want higher returns can put their money into certificates of deposit. The trade-off for these higher returns is lower liquidity. CDs, also known as time deposits, tie up cash for a set period of time—typically several months or longer. If you take your money out of a CD before the end date, you will pay a penalty that amounts to a percentage of the interest you would have earned.

Why are people willing to trust their money to banks? The main reason is safety. **The risk [risk: the chance of losing money or of failing in some way] , or chance of losing money, is very low with any bank deposit, thanks to the Federal Deposit Insurance Corporation.** Congress established this federal agency in 1933 to help stabilize the banking system during the Great Depression. Today, nearly all bank deposits are insured by the FDIC for up to \$100,000 per depositor. Should a bank fail, the FDIC guarantees that depositors will get their money back up to that amount.

Banks Make Loans to Borrowers

Banks use the money deposited by savers to make loans to other customers. Bank loans come in three forms: commercial loans, consumer loans, and mortgage loans.

Commercial loans. Businesses often take out commercial loans [commercial loan: money borrowed by a business to pay expenses] to buy machinery, equipment, and materials or to pay labor costs. Before making such a loan, banks consider the firm's financial condition and borrowing history as well as the general state of the economy.

Consumer loans. Individual borrowers take out consumer loans [consumer loan: money borrowed by an individual to make major purchases] to make major purchases such as a new car or boat. These loans are often called **installment loans [installment loan: borrowed money that is typically paid back in equal monthly payments]** , because most are paid back in equal monthly installments, or payments. Before making a consumer loan, the bank looks at the individual's **credit history [credit history: the record of a person's borrowing and repayment of loans]** . This is a history of the person's past borrowing along with his or her record of repaying loans on time and in full.

Individuals can take out loans to buy smaller items by making their purchases with a credit card. Using a credit card is easy—so easy that many people charge more than they can afford. Those who cannot pay off their credit card bills each month are charged interest on their unpaid balances by the bank that issued the card. Interest rates for credit card debt are generally much higher than for other kinds of loans. For many cardholders, the result of overcharging is an ever-increasing pile of debt.

Mortgage loans. Banks also offer longer-term loans to consumers and businesses in the form of mortgages. A mortgage [mortgage: money borrowed to buy a house, an office building, land, or other real estate] is a loan used to buy a house, an office building, land, or other real estate. The term of a mortgage typically ranges from 15 to 30 years.

As with any loan, a mortgage is part **principal [principal: the amount of money borrowed, or the amount of money still owed on a loan, apart from the interest]** —the amount of money actually borrowed—and part interest on the principal. You might be surprised at the total cost of paying off a home mortgage. A house purchased for \$220,000 with a traditional 30-year mortgage at a fixed interest rate of 5 percent per year, and paid in monthly installments, could end up costing the buyer more than \$400,000 by the time the loan is paid off.

How Banks Make a Profit



This family bought a new home with the help of a long-term bank loan called a mortgage. Homebuyers who take out mortgages must pay back the principal, or amount borrowed, as well as interest on the principal. Over the course of several years, interest can add considerably to the overall cost of a home purchase.

In their role as financial intermediaries, banks channel funds from savers to borrowers by taking money deposited into various accounts and using it to make loans. In the process, banks profit by charging more interest on loans than they pay on deposits. For borrowers, interest represents the cost of using someone else's money. For savers, interest represents payment for letting someone else use their money.

How, you might wonder, can a bank lend out depositors' money and still promise to return that money to its depositors on demand? The answer is that banks don't lend out all the money they take in. They are required by law to keep a certain fraction of it in reserve to cover depositors' withdrawals from their accounts. For example, suppose you deposit \$1,000 into a checking account. Your bank may be required to keep one-tenth, or \$100, in reserve. That would leave \$900 for the bank to lend out and charge interest on.

This system—whereby banks keep a fraction of deposits in reserve and make loans with the rest—is known as fractional reserve banking [fractional reserve banking: a system in which banks keep a portion of deposits in reserve and make loans with the rest]. The system keeps enough money available for withdrawals while allowing banks to profit from the rest. The fraction that banks are required to keep on hand is set by the Federal Reserve System, which was established in 1913 to oversee the banking system.

The Federal Reserve: Our Nation's Central Bank

The Federal Reserve System, commonly known as the Fed, is the central bank of the United States. A central bank does not serve individual consumers and businesses, and making a profit is not one of its goals. The Fed's customers are the nation's thousands of banks, and its goals involve keeping the entire banking system stable and healthy. **The Fed provides several important financial services.**

Holding reserves. The Fed requires each bank to keep a fraction of its deposits in reserve. Some of that reserve takes the form of currency in the bank's vault, and some goes into an account set up for the bank at the Fed. In this way, the Fed serves as a bank for banks.

Providing cash and loans. When a bank needs cash to meet withdrawal demands, the Fed supplies it from the bank's account. The Fed also lends money to banks when they run short of funds.

Clearing checks. If you write a check to a store and the store deposits the check into its account with a different bank, the Fed takes care of transferring funds from your bank to the store's bank. This process is known as **check clearing [check clearing: the transfer of funds from one bank or account to another as a result of cashing a check]**. The Fed clears billions of checks each year.

Linking banks electronically. The Federal Reserve and nearly all of the nation's banks are linked electronically. Using this electronic network, banks can quickly transfer funds from one financial institution to another.

The Fed Manages the Banking System

The Federal Reserve does more than provide services. It also manages the banking system to ensure that banks operate according to sound financial principles.

Another important job of the Fed is to control the nation's money supply. It does this in part by setting reserve requirements, the minimum fraction of deposits that banks must keep in their own vaults or at the Federal Reserve. The Fed also issues Federal Reserve notes, the paper currency we know as dollars. Through all of its activities the Fed aims to provide liquidity—to make sure consumers and businesses have ready access to money.

The Fed's structure aids in the task of managing the banking system. A seven-member Board of Governors oversees the Federal Reserve System from its headquarters in Washington, D.C. From there, it formulates Fed policies related to the money supply and sets reserve requirements.

Twelve regional Federal Reserve Banks carry out many of the system's day-to-day activities. Each Reserve Bank provides financial services to its region's banks and supervises their operations. Reserve Banks also feed economic information about their regions to the Board of Governors.

About 30 percent of the banks in the United States are members of the Federal Reserve System. Members include all national banks—commercial banks chartered by the federal government—and many state-chartered banks. All commercial banks, whether Fed members or not, enjoy the same privileges when it comes to borrowing from the Fed and must follow the Fed's regulations. And when the Fed takes steps to adjust the money supply, all banks feel the effects.