How Banks Work

The funny thing about how a bank works is that it functions because of our trust. We give a bank our money to keep it safe for us, and then the bank turns around and gives it to someone else in order to make money for itself. Banks can legally extend considerably more credit than they have cash. Still, most of us have total trust in the bank's ability to protect our money and give it to us when we ask for it. Why do we feel better about having our money in a bank than we do having it under a mattress? Is it just the fact that they pay interest on some of our accounts? Is it because we know that if we have the cash in our pockets we will spend it? On the other hand, is it simply the convenience of being able to write checks and use debit cards rather than carrying cash? Any and all of these may be the answer, particularly with the conveniences of electronic banking today. Now, we do not even have to manually write that check -- we can just swipe a debit card or click the "pay" button on the bank's Web site.

In this article, we'll look into the world of banking and see how these institutions work and why we should (or shouldn't) trust them with our hard earned cash

What is a bank?

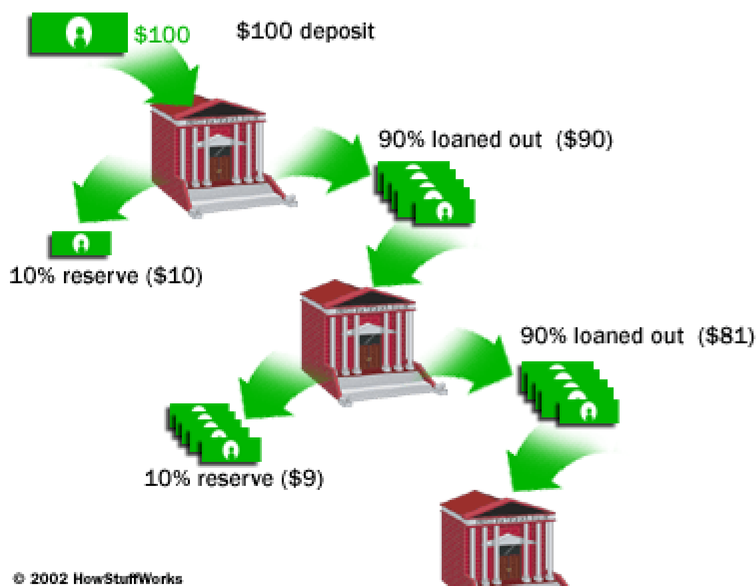
According to Britannica.com, a bank is:

> **an institution that deals in money and its substitutes and provides other financial services. Banks accept deposits and make loans and derive a profit from the difference in the interest rates paid and charged, respectively**.

Banks are critical to our economy. The primary function of banks is to put their account holders' money to use by lending it out to others who can then use it to buy homes, businesses, send kids to college...

When you deposit your money in the bank, your money goes into a big pool of money along with everyone else's, and your account is credited with the amount of your deposit. When you write checks or make withdrawals, that amount is deducted from your account balance. Interest you earn on your balance is also added to your account.

Banks **create money** in the economy by making loans. The amount of money that banks can lend is directly affected by the reserve requirement set by the Federal Reserve. The reserve requirement is currently 3 percent to 10 percent of a bank's total deposits. This amount can be held either in cash on hand or in the bank's reserve account with the Fed. To see how this affects the economy, think about it like this. When a bank gets a deposit of $100, assuming a reserve requirement of 10 percent, the bank can then lend out $90. That $90 goes back into the economy, purchasing goods or services, and usually ends up deposited in another bank. That bank can then lend out $81 of that $90 deposit, and that $81 goes into the economy to purchase goods or services and ultimately is deposited into another bank that proceeds to lend out a percentage of it.



In this way, money grows and flows throughout the community in a much greater amount than physically exists. That $100 makes a much larger ripple in the economy than you may realize!

Why does banking work?

Banking is all about **trust**. We trust that the bank will have our money for us when we go to get it. We trust that it will honor the checks we write to pay our bills. The thing that is hard to grasp is the fact that while people are putting money into the bank every day, the bank is **lending** that same money and more to other people every day. Banks consistently extend more credit than they have cash. That is a little scary; but if you go to the bank and demand your money, you will get it. However, if everyone goes to the bank at the same time and demands their money (a **run on the bank**), there might be problem.
Even though the Federal Reserve Act requires that banks keep a certain percentage of their money in **reserve**, if everyone came to withdraw their money at the same time, there would not be enough. In the event of a bank failure, your money is protected as long as the bank is insured by the Federal Deposit Insurance Corporation (**FDIC**). The key to the success of banking, however, still lies in the confidence that consumers have in the bank's ability to grow and protect their money. Because banks rely so heavily on consumer trust, and trust depends on the perception of integrity, the banking industry is highly regulated by the government.

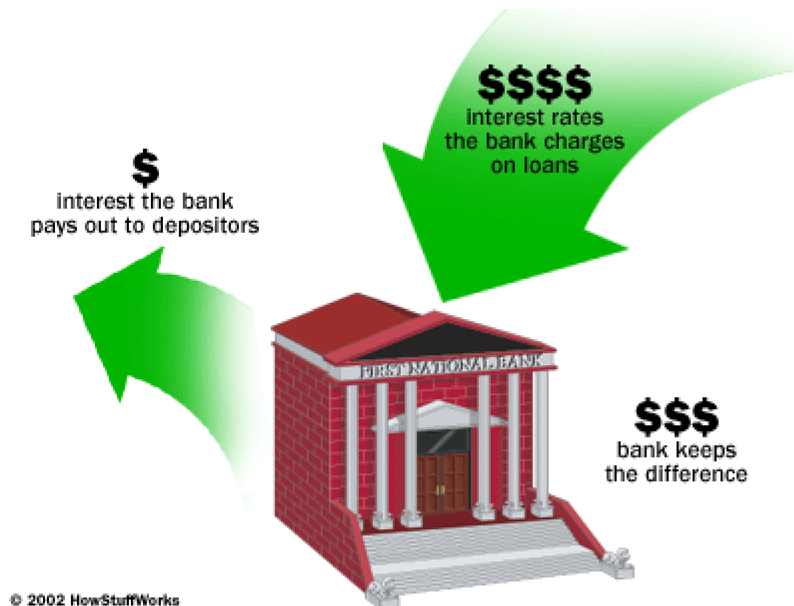
Types of Banks

There are several types of banking institutions, and initially they were quite distinct. **Commercial banks** were originally set up to provide services for businesses. Now, most commercial banks offer accounts to everyone.
Savings banks, savings and loans, cooperative banks and credit unions are actually classified as **thrift institutions**. Each originally concentrated on meeting specific needs of people who were not covered by commercial banks. **Savings banks** were originally founded in order to provide a place for lower-income workers to save their money. **Savings and loan associations** and **cooperative banks** were established during the 1800s to make it possible for factory workers and other lower-income workers to buy homes. **Credit unions** were usually started by people who shared a common bond, like working at the same company (usually a factory) or living in the same community. The credit union's main function was to provide emergency loans for people who could not get loans from traditional lenders. These loans might be for things like medical costs or home repairs.

Now, even though there is still a differentiation between banks and thrifts, they offer many of the same services. Commercial banks can offer car loans, thrift institutions can make commercial loans, and credit unions offer mortgages!

How do banks make money?

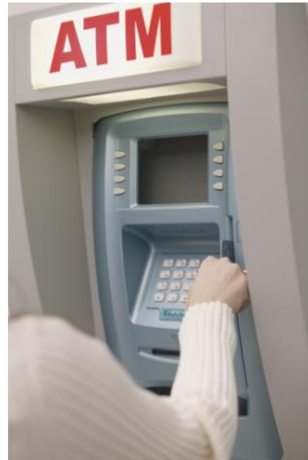
Banks are just like other businesses. Their product just happens to be money. Other businesses sell widgets or services; banks sell money -- in the form of loans, certificates of deposit (CDs) and other financial products. They make money on the interest they charge on loans because that interest is higher than the interest they pay on depositors' accounts.



The **interest rate** a bank charges its borrowers depends on both the number of people who want to borrow and the amount of money the bank has available to lend. As we mentioned in the previous section, the amount available to lend also depends upon the reserve requirement the Federal Reserve Board has set. At the same time, it may also be affected by the funds rate, which is the interest rate that banks charge each other for short-term loans to meet their reserve requirements. Check out How the Fed Works for more on how the Fed influences the economy.

Loaning money is also inherently risky. A bank never really knows if it will get that money back. Therefore, the riskier the loan the higher the interest rate the bank charges. While paying interest may not seem to be a great financial move in some respects, it really is a small price to pay for using someone else's money. Imagine having to save all of the money you needed in order to buy a house. We would not be able to buy houses until we retired!

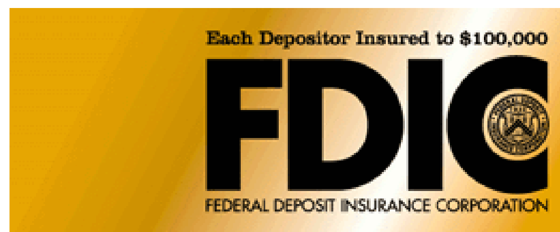
Banks also charge **fees** for services like checking, ATM access and overdraft protection. Loans have their own set of fees that go along with them.



Another source of income for banks are **investments** and **securities**.

How safe is your money in a bank?

The 12 regional Reserve Banks act as the service division of the Federal Reserve -- they carry out the monetary policy set by the Federal Reserve Board and regulate and supervise financial institutions. The agency that charters the bank is also responsible for conducting on-site examinations to make sure the bank is complying with banking laws. In addition to this supervision, your money is also protected by insurance.



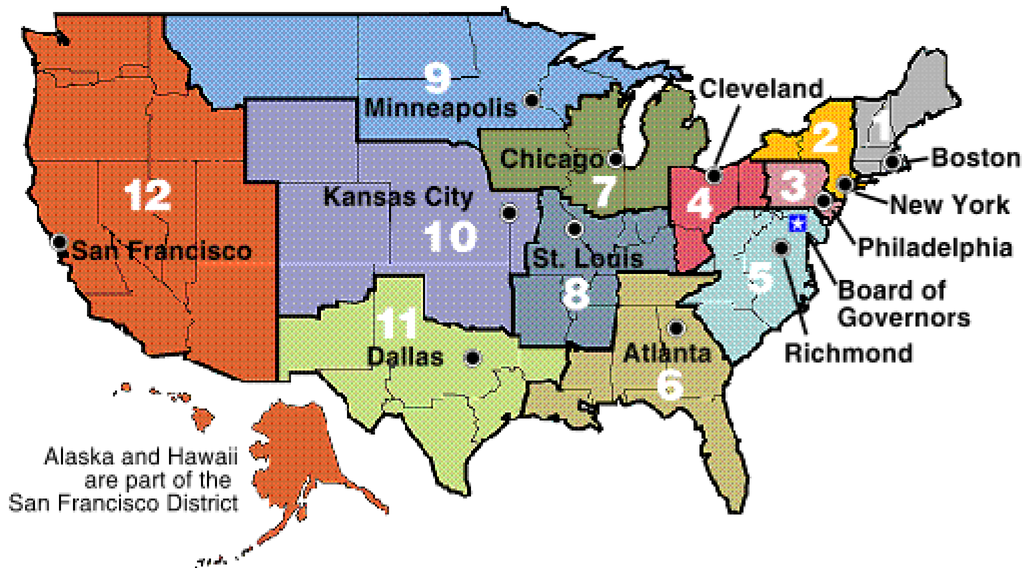
That "FDIC" logo you see as you walk in the door means that you hold insurance on your deposits. Depositors are typically protected for up to $100,000.

Deposit insurance came about because of rumors of banking trouble that lead to panics and everyone running to the bank to withdraw all of their money. It did not take much to make people uneasy about the security of their money in the bank. If they heard of the slightest hint of trouble, they ran to the bank to withdraw. This lead to the failure of many banks and huge losses of savings for many people. This roller coaster of personal finance lasted for many years and throughout the Great Depression of the 1930s. Finally, in 1934, Congress established the **Federal Deposit Insurance Corporation** (FDIC), which initially provided deposit insurance coverage of $2,500 per depositor. This greatly improved the security of banks and reduced the number of bank failures by almost 4,000 from 1933 to 1934.

Public confidence in the banking system has improved tremendously since the FDIC was established. The trust that depositors need in order to make the system work is maintained, and the economy keeps humming.

Banks also carry **private banking insurance** -- specially designed private coverage to protect deposits in the case of burglaries, robberies, vandalism, etc.

The Twelve Federal Reserve Districts



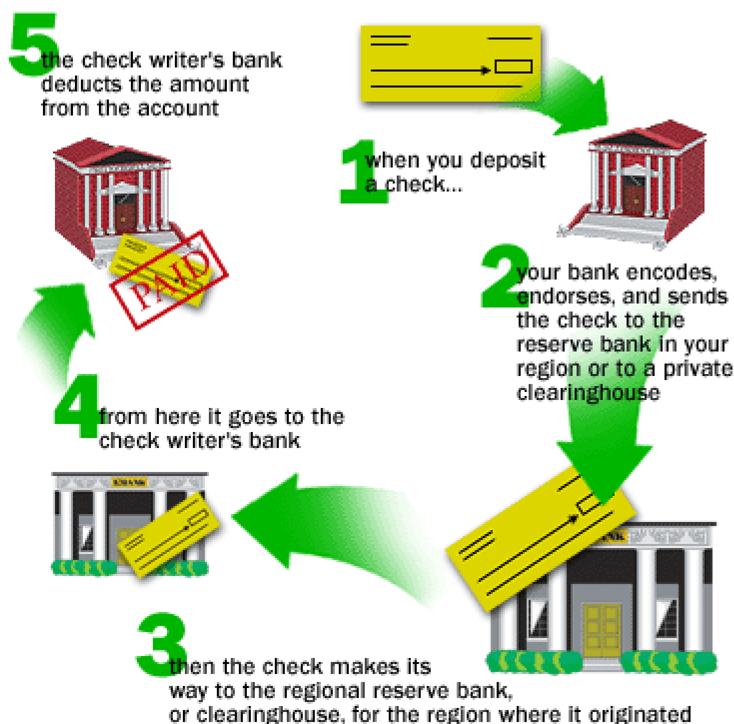
The Federal Reserve officially identifies Districts by number and Reserve Bank city.

In the 12th District, the Seattle Branch serves Alaska, and the San Francisco Bank serves Hawaii. The System serves commonwealths and territories as follows: the New York Bank serves the Commonwealth of Puerto Rico and the U.S. Virgin Islands; the San Francisco Bank serves American Samoa, Guam, and the Commonwealth of the Northern Mariana Islands. The Board of Governors revised the branch boundaries of the System in February 1996.

Checking Accounts

Banks offer many financial products for their depositors. The checking account is one of the most common ones. It is convenient because it lets you buy things without having to worry about carrying the cash -- or using a credit card and paying its interest. While most checking accounts do not pay interest, some do -- these are referred to as **negotiable order of withdrawal** (NOW) accounts. Some say that checks have been around since about 352 B.C. in the Roman Empire. It appears that checks really started becoming popular in Holland in the 1500 to 1600s. Dutch "cashiers" provided an alternative to keeping large amounts of cash at home and agreed to hold depositors' money for safekeeping. For a fee, they would pay the depositors' debts from the account based on a note that the depositor would write -- sounds a lot like a check!

Today's banks do the same thing. It became a little more complicated when many banks became involved and money needed to be shifted from one bank to the next. To make things easier, banks now have a system of check "**clearinghouses**." Banks either send checks through the Federal Reserve or use a private clearinghouse to transfer the funds and clear the check. Here is a diagram of how that works.



Loans, Checks and Savings

Aside from checking accounts, they offer loans, certificates of deposits and money market accounts, not to mention traditional savings accounts. Some also allow you to set up individual retirement accounts (IRAs) and other retirement or education savings accounts. There are, of course, other types of accounts being offered at banks across the country, but these are the most common ones.

- **Savings accounts** - The most common type of account, and probably the first account you ever had, is a savings account. These accounts usually require either a low minimum balance or have no minimum balance requirement, and allow you to keep your money in a safe place while it earns a small amount of interest each month. In standard practice, there are no restrictions on when you can withdraw your money.

- **Money market accounts** - A money market account (MMA) is an interest-earning savings account with limited transaction privileges. You are usually limited to six transfers or withdrawals per month, with no more than three transactions as checks written against the account. The interest rate paid on a money market account is usually higher than that of a regular passbook savings rate. Money market accounts also have a minimum balance requirement.

- **Certificates of deposit** - These are accounts that allow you to put in a specific amount of money for a specific period of time. In exchange for a higher interest rate, you have to agree not to withdraw the money for the duration of the fixed time period. The interest rate changes based on the length of time you decide to leave the money in the account. You cannot write checks on certificates of deposit. This arrangement not only gives the bank money they can use for other purposes, but it also lets them know exactly how long they can use that money.

- **Individual retirement accounts and education savings accounts** - These types of accounts require that you keep your money in the bank until you reach a certain age or your child enters college. There can be penalties with these types of accounts, however, if you use the money for something other than education, or if you withdraw the money prior to retirement age.