Student Guide

Class #12 – Banking System Overview

Banks are financial institutions that help people save and manage their money. Banks offer a range of financial products, services, and information to their customers.

Commercial Banks

Commercial banks provide services to individuals and businesses. People can open a savings account at a bank where they can deposit money and earn interest on it. People can also take out loans from a bank to make large purchases like a car or a house. Banks also help people make payments by providing them with debit and credit cards. When you use a debit card to make a purchase, money is taken directly from your account. When you use a credit card, you borrow money from the bank and pay it back later with interest. Banks can also help people invest their money to grow their wealth.

Commercial banks help businesses by providing them with the money to operate, grow, and invest in their operations. These banks also offer services like accepting deposits and providing businesses with access to credit, which can help them manage their money and make important financial decisions.

Investment Banks

Investment banks help organizations to raise capital by selling stocks and/or bonds to investors. Organizations can use the funds raised for research and development, to expand business operations, to open new locations, etc. Investment banks also help businesses with mergers and acquisitions, where one company buys another company.

Central Banks

Central banks serve as the "banker's bank." Banks work with central banks. The central bank of the United States is U.S. Federal Reserve. The U.S. Federal Reserve helps to keep the economy stable by controlling the supply of money and influencing interest rates. The U.S. Federal Reserve operates under a dual mandate:

1) Maintain price stability, and
2) Maximize sustainable employment.

The U.S. Federal Reserve adjusts monetary policies when prices become unstable (ex. inflation rises) and/or when employment is not at maximum sustainable levels.

The U.S. Federal Reserve can help to control the amount of money in the economy by adjusting the interest rates it charges banks to borrow money. If the interest rates are high, it becomes more expensive for banks to borrow money. Banks are then less likely to make loans. This can help to reduce the amount of money in the economy and prevent inflation.

Let's see how some of this works in practice.

Mia opened a savings account at her local bank when she started working the summer job at her parents' bakery.

Mia wanted to deposit her income into her savings account until she needed her money. Each time the bakery ran payroll, Mia's income was directly deposited into her savings account at her bank.

Mia's bank has an account with the U.S. Federal Reserve. The bank keeps some of Mia's deposits, along with some deposits from other customers, in the bank's account at the U.S. Federal Reserve. The bank uses the rest of the money to make loans to people and organizations who want to borrow money.

Mia's bank collects interest from the loans it makes. This is how Mia's bank makes money. Interest income to the bank is an interest expense to people and organizations that borrow from the bank.

Each month, the bank also pays Mia some interest on the money she keeps in her savings account. Interest income to Mia on her savings account balance is an interest expense of her bank.

When Mia needs her money, she can withdraw it from the bank. Mia can also use a debit card to pay for purchases, which reduces her bank account balance. When Mia and other customers withdraw money or make payments, the bank may need to withdraw funds from its account at the U.S. Federal Reserve.

The bank can also borrow from the U.S. Federal Reserve, as needed.

Exercise: Mia's income paid to her by the bank on Mia's savings account balance is what type of income?

Checking and Savings Accounts

One of the primary services of banks is to provide customers the ability to deposit money safely and access it when needed. The most common financial products to do this are checking accounts and savings accounts. The following table summarizes general features of these accounts. weird

Checking Account	Savings Account
Intended for **regular** transactions in/out	Intended for **periodic** transactions in/out
Transact anytime with **few** restrictions on funds accessibility and withdrawals	**Some restrictions** on funds accessibility and withdrawals
More features; generally, includes ATM access, **check writing**, **debit card payments**, online banking, **online bill payment**, and wire transfers	**Fewer** features; generally, includes ATM access, online banking, and wire transfers
Generally, earns **0%** interest rate	**Earns >0%** interest rate

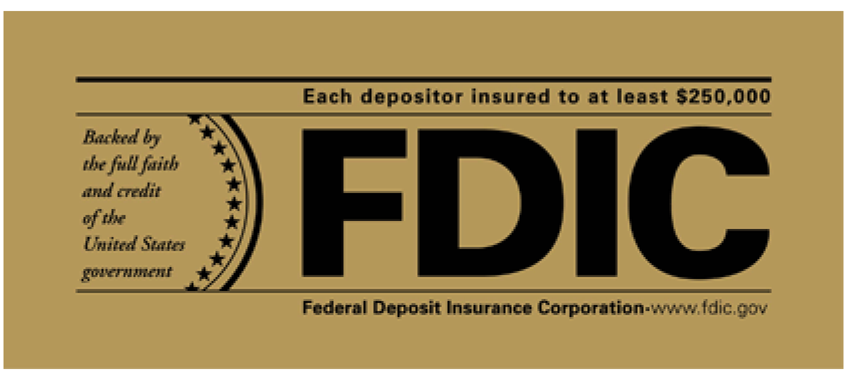
Federal Deposit Insurance Corporation ("FDIC")

Customers deposit their money at banks because banks are a safe place to keep money until customers need it. If customers lost trust in a bank, customers would withdraw their funds.

Exercise: What might cause customers to lose confidence in a bank?

If many customers did this at once, it is known as a bank run. Some bank runs would cause banks to go bankrupt, or insolvent, because the bank may not have enough money on hand to pay out many depositors at once. One of the greatest risks of early banks were bank runs.

In 1933, the U.S. Government stepped in and created the FDIC.



Through the FDIC, the U.S. Government guarantees the value of accounts up to certain amounts. Subject to certain rules that banks follow, depositors' accounts would be protected, even if a bank went insolvent. The FDIC was created to provide depositors with peace of mind.

If people do not trust the banking system, then people would not engage in commercial activities. Commercial activities are necessary to keep the economy moving.

Key Takeaways

1) Banks provide wide ranges of products, services, and information to help people and organizations manage their financial needs.
2) Central banks work to keep the economy stable.