Capital Markets
INITIATIVE

A Primer on Banking

Lauren Oppenheimer and David Hollingsworth

CAPITAL MARKETS 101

A third way fresh thinking publication

TABLE OF CONTENTS

INTRODUCTION

From Thomas Jefferson's opposition to the First Bank of the United States to the New Deal response to the financial excesses of the 1920s, an anti-banking streak is a part of Americans' psyche. On the other hand, banks have also been a key driver in America's transition from a colonial outpost to the most powerful economic nation on Earth.

This primer tells the basic story of commercial banks and why they matter. It explains how commercial banks developed, how they make money, and why they need regulation. Whether or not distrust of banks is merited, without a healthy banking system our country would be worse off.

TRADE, GOLD, AND THE FIRST BANK

Today, we take for granted the ability to keep our money safely in a bank instead of under a mattress, that we will be paid to keep our money at the bank, and that we have the option of withdrawing it at any time. Commercial banks are an important tool by which savings—that might otherwise be doing nothing—are multiplied and made available to businesses and entrepreneurs through loans. By transferring savings to productive investment, banks help propel economic growth. How did all of this start?

Trade has occurred since the beginning of recorded history when individuals bartered directly for goods and services. As societies developed, the creation of gold coins facilitated the expansion of long distance trade by creating a recognized medium of exchange (gold has certain properties—such as being easily identifiable and hard to fake—that make it an ideal medium of exchange). The use of gold coins encouraged economic expansion.[1]

By transferring savings to productive investment, banks help propel economic growth.

While gold coins were an important development, they were impractical for a modern economy. It is hard to carry a large amount of gold without attracting attention and the fear of being robbed was a real concern.[2]

Eventually, groups of merchants got together to form banks that would securely hold their gold at a central location. The bank would assure the quality of the gold being deposited and issue the depositor a certificate representing the value of the gold. The customer could then present the certificate at any time to redeem their gold.[3] The banks charged a fee for safely holding people's money.

At first, banks kept 100% of the deposits they collected on hand. But banks soon discovered that only a few people asked for their gold back on any given day, and that any gold returned to depositors was often cancelled out by new deposits. The remainder of the gold sat idle in the vaults.

Banks realized that they could earn a profit by lending out the gold reserves that sat in their vaults day after day. They did not lend actual gold coins, but rather created their own deposit certificate and loaned it to the borrower. For example, a merchant would get a loan from a bank in the form of a certificate of deposit. The merchant would take that certificate, use it to purchase his goods, and then pay back the banker with the proceeds of the sale of goods, plus interest.[4]

This system was successful. By significantly expanding the amount of money available to businesses and individuals, banks fueled economic growth. Money that would have been kept in a vault or hidden under a mattress was now available for others to use productively.

FRACTIONAL RESERVE BANKING

Fractional reserve banking is a term that describes how banks set aside a certain percentage of their reserves—the savings they collect from depositors—for the day-to-day needs of depositors who want access to their funds, and lend the rest out. Today, the government sets the minimum level for the reserves that banks must keep on hand. These are called *reserve requirements*.[5]

For example, say reserve requirements are set at 10%. If you deposited $100 at your local commercial bank, it would be required to keep $10 on reserve, and could loan out $90 to businesses and individuals.

This is how banks contribute to economic growth. By only keeping a fraction of their deposits in reserve, more businesses are able to get loans than would otherwise be the case. In other words, if a bank took all of the money they collected and kept it for depositors to access if needed, they would have no money to lend. So banks use the money they collect as a base to make loans.

HOW BANKS MAKE MONEY

Banks make money on the difference between what they pay for deposits and what they charge for loans—this is also known as "the spread." According to economists Frederic Mishkin and Stanley Eakins, banks become experts in the production of information about firms so that they can sort out good credit risks from bad ones.[6] Because they develop an expertise in judging the risk associated with each borrower, banks are able to channel savings to productive investment.

Banks have become more complex, though their basic function of channeling savings to productive investment remains the same. Below are three areas that describe how banks currently manage their assets and liabilities to make a profit:[7]

1) **Liquidity Management** – When a bank has enough reserves on hand to meet the demand of depositors it means they are "liquid." Banks are only required to keep a fraction of their deposits at one time. They try to keep the least amount on hand (because they make no money), while also making sure they never run short when depositors come asking for their money. Failing to meet withdrawals for even one day is extremely destructive.

2) **Asset Management** – Banks lend to earn money, so loans are actually assets. They provide income streams to banks and often come with collateral. A bank maximizes profits by seeking the largest profits on its loans—meaning it looks for credit-worthy borrowers that will pay a high rate of interest and are unlikely to default on their loans. Banks try to buy low-risk

securities that have high returns when they don't believe they have profitable lending opportunities. Banks also want to keep highly liquid securities—such as Treasury bills—that can be sold quickly for cash in the event of an unexpected deposit outflow. While banks want to minimize the risks associated with making loans and buying securities, being too conservative can be costly—it is expensive to maintain deposit accounts (i.e. maintaining branches, paying employees, processing paperwork, etc.).

3) **Liability Management** – Banks want your deposits, but they are actually liabilities. They provide cash for banks to lend, but they can also be claimed by depositors on a moment's notice. Before the 1960s, due to a rigid division of the financial sector, banks relied on checking and savings accounts as the primary source of their funding, and did not compete with each other to secure deposits. However, as markets developed, there was an expansion of bank-to-bank overnight lending, which meant that banks no longer had to rely solely on deposits for funding. Banks could now borrow from other banks and financial institutions on a daily basis if they had a profitable loan opportunity to exploit or to cover any capital shortfalls caused by bad loans or deposit withdrawals.

BANKING INSTABILITY

During normal economic times, fractional reserve banking is a significant contributor to economic growth. However, this system does have built-in instability. The successful functioning of the fractional reserve banking system depends on the fact that many depositors will not come to retrieve their savings at the same time. This is usually a safe assumption.

However, if depositors fear that a bank could become insolvent they may all try to get their money out of the bank before it runs out of cash. Because most bank assets are illiquid—which means they cannot be easily sold—they will be unable to meet the sudden withdrawals from many depositors because they only have a small fraction of reserves on hand at any given time. This is known as a *bank run*, and runs have occurred throughout the history of banking.

When there is a bank panic, banks don't lend. When banks don't lend, businesses can't grow.

A run on one bank can call into question the solvency of other banks, causing runs on them as well. When one bank run cascades into further bank runs, it is called a *bank panic*.

The United States experienced regular bank panics in its early history—1819, 1836, 1857, 1873, 1893, 1907, and 1929.[8] The failure of one bank does not mean that there will be a run on other banks, but the bigger and more important the failed financial institution, the more likely its failure is to cascade through the entire system.

When there is a bank panic, banks don't lend. When banks don't lend, businesses can't grow. When business can't grow, people lose their jobs. When people lose their jobs, they withdraw their savings from banks. Bank panics cause enormous damage to an economy, and it often takes years to fully recover.

In fact, according to *The Economist*, we may currently be witnessing a slow motion bank run in Europe.[9] Banks have assets (sovereign debt) on their books that have declined in value; they have a high ratio of outstanding loans to depositor's cash; banks are reluctant to lend; and businesses struggle to get loans and so forth.

REGULATION OF THE BANKING SECTOR

Given the inherent instability of fractional reserve banking, it may seem like this system should be replaced with something more stable. However, fractional reserve banking has brought a tremendous amount of growth and prosperity.

To go back to a financial world without fractional reserve banking would be to go back to the Middle Ages. As author George Cooper points out, "Credit creation must stay, and we must find a way to live with the instability that comes with it; it is better to have a volatile and growing economy than a stable and stagnant one."[10]

Since it would be unwise to end fractional reserve banking and return to a world where banks kept 100% of their deposits and made no loans, governments have moved to regulate banks to control the inherent instability. Most government regulation of the banking sector is intended to reduce volatility and ensure the stability of banks operating on a fractional reserve basis—including the protection of depositors.

Most government regulation of the banking sector is intended to reduce volitility and ensure stability of banks.

Take for example Federal Deposit Insurance Corporation (FDIC) insurance. Prior to 1933, during bank panics there was typically a rapid withdrawal of deposits from banks, and even financially sound banks struggled to survive. FDIC insurance—enacted in 1933—puts the full faith and credit of the federal government behind deposits in commercial banks that meet FDIC guidelines, now up to $250,000.

Commercial banks with FDIC insured deposits have suffered almost no runs since the establishment of the insurance fund, as depositors have confidence that their savings will be secure in the event of a bank failure. Banks are assessed a fee to pay for the insurance fund based on the amount of their insured deposits.[11] However, there is a concern that if depositors know their money is safe, they won't monitor the lending practices of their bank. Given this concern, regulators circumscribe fractional reserve bank activities in other ways to limit the riskiness of their lending practices.

The Federal Reserve also promotes the stability of a fractional reserve banking system by acting as a lender of last resort. As previously discussed, it is disruptive for banks to sell their loans and other long-term assets to meet short-term funding needs, for both banks and their borrowers. The Federal Reserve provides liquidity to banks experiencing a bank run or other problems with their short-term funding by loaning them money through its discount window.[12] This prevents problems at one or a few banks from spreading throughout the financial system.

To be clear, the Federal Reserve is designed to lend to sound banks—using the bank's long-term assets as collateral. The Federal Reserve is not designed to lend to insolvent banks with poor assets. Of course, in times of national economic emergency, such as during the financial crisis of 2008, the Federal Reserve may be required to take actions to save the financial system beyond its normal role of providing liquidity to banks.

CONCLUSION

Commercial banks remain a vital part of the financial system. They are one of the few institutions that allow anyone to open an account and then withdraw that money whenever the need arises. They also allow regular depositors to earn a return on their savings. Commercial banks multiply the savings of individuals by making loans to businesses and entrepreneurs who can use those funds productively. This is how commercial banks facilitate economic growth, and without them our economy would be less dynamic with fewer jobs and less wealth.

It is crucial to understand how banks work and why they are critical for the U.S. economy—for while Americans may rue the practices of individual banks, our country must maintain a healthy banking sector to succeed.

THE CAPITAL MARKETS INITIATIVE

About CMI

Third Way created the Capital Markets Initiative (CMI) to unpack the opaque issues that decision makers confront when working on financial policy. Instead of the dense approach used in a basic economics or finance class, CMI's goal is to make these topics much more lively and accessible.

The different formats—timely short papers called Hot Issue Briefs, a dynamic distinguished speaker series called Capital Markets 101, and informative primers on the basics—allow policymakers to more easily understand how capital markets really work and add value.

The CMI Staff

Jim Kessler is the Senior Vice President for Policy and co-founder of Third Way. He can be reached at jkessler@thirdway.org.

Lauren Oppenheimer is the Senior Policy Advisor for CMI and can be reached at loppenheimer@thirdway.org.

David Hollingsworth is the Policy Advisor for CMI and can be reached at dhollingsworth@thirdway.org.

For more information about Third Way or the Capital Markets Initiative, please visit www.thirdway.org.

* * *

ENDNOTES

1 George Cooper, "Origins of the Financial Crisis," Harriman House, United Kingdom, September 1, 2008, pp. 45-46, Print.

2 Ibid.

3 Cooper.

4 Ibid.

5 Frederick Mishkin and Stanley Eakins, "Financial Markets and Institutions," Addison Wesley, 2006, p. 428, Print.

6 Mishkin and Eakins, p.28

7 Ibid, pp. 431-435.

8 John Steele Gordon, "A Short Banking History of the United States," *The Wall Street Journal*, October 10, 2008. Accessed January 31, 2012. Available at: http://online.wsj.com/article/SB122360636585322023.html.

9 "Chest Pains: Europe's sovereign-debt crisis is constricting the flow of money to its banks," *The Economist*, August 27, 2011, Print. Accessed on April 30, 2012. Available at: http://www.economist.com/node/21526926.

10 Cooper, p. 64.

11 Mark Jinkling and Edward V. Murphy, "Who Regulates Whom? An Overview of U.S. Financial Supervision," Congressional Research Service, December 8, 2010. Accessed January 31, 2012. Available at: http://assets.opencrs.com/rpts/R40249_20101208.pdf.

12 "The Federal Reserve System, Purposes & Functions," Report, Federal Reserve Board, June 2005. Accessed April 20, 2012. Available at: http://federalreserve.gov/pf/pdf/pf_complete.pdf.

NOTES