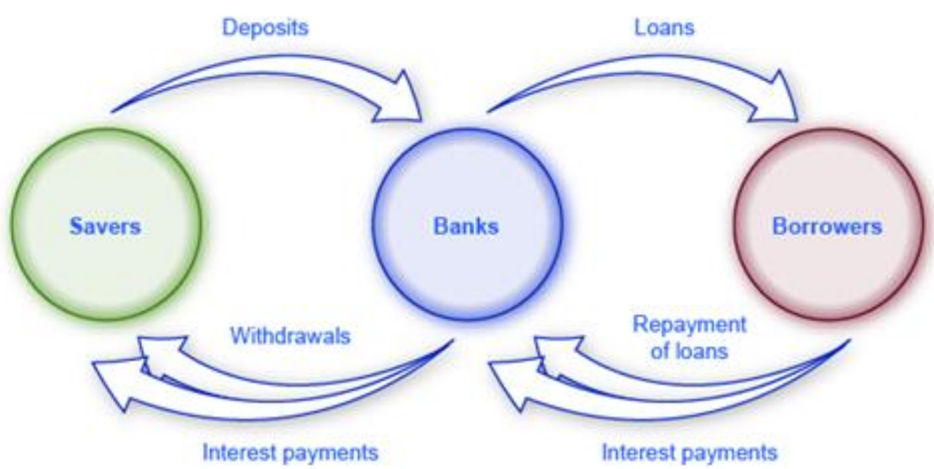
What Do Banks Do?

Banking is a difficult concept to understand. There are a lot of moving pieces, and sometimes it's like they have their own language! It's important to understand the basics of banking so you can ensure that you know what is happening with your money. Below are excerpts from an article (edited to break the concept a little easier) that tries to break down the basics of banking.

While reading, keep this image in mind.



The Banking System

Accounting for trillions in assets worldwide, the banking system is a crucial component of the global economy. While money-changing and money-lending may be as old as money, banking dates back to 15th century medieval Italy, and played a major role in the rise of the Italian city-states as world economic powers.

Banks are just one part of the world of financial institutions, standing alongside investment banks, insurance companies, finance companies, investment managers and other companies that profit from the creation and flow of money. As financial intermediaries, banks stand between depositors who supply capital and borrowers who demand capital. 'Capital' refers to the wealth that is owned by individuals or a company. Given how much commerce and individual wealth rests on healthy banks, banks are also among the most heavily regulated businesses in the world.

"Texas Gateway." *Cell Specialization and Differentiation | Texas Gateway*, www.texasgateway.org/resource/133-role-banks.
Stephen D. Simpson, CFA. "The Banking System." *Investopedia*, Investopedia, 30 Mar. 2017, www.investopedia.com/university/banking-system/.

Accept Deposits / Make Loans

At the most basic level, what banks do is simple. Banks accept deposits from customers, raise capital from investors or lenders, and then use that money to make loans and provide financial services to customers. These loans are then used by people and businesses to buy goods or expand business operations, which in turn leads to more deposited funds that make their way to banks.

If banks can lend money at a higher interest rate than they have to pay for funds and operating costs, they make money.

Provide Safety

Banks also provide security and convenience to their customers. Part of the original purpose of banks, and the goldsmiths that predated them, was to offer customers safe keeping for their money. Of course, this was back in a time when a person's wealth consisted of actual gold and silver coins, but to a large extent this function is still relevant. By keeping physical cash at home, or in a wallet, there are risks of loss due to theft and accidents, not to mention the loss of possible income from interest. With banks, consumers no longer need to keep large amounts of currency on hand; transactions can be handled with checks, debit cards or credit cards instead.

While banks do not keep gold or silver bullion as currency on hand anymore, many, if not most, banks still maintain vaults and will rent out space to customers, in the form of safe deposit boxes. This allows customers to keep precious or irreplaceable items in a secure setting and gives the bank an opportunity to earn a little extra money, without risk to its capital.

Deposits

The largest source by far of funds for banks is deposits; money that account holders entrust to the bank for safekeeping and use in future transactions, as well as modest amounts of interest. Generally referred to as "core deposits," these are typically the checking and savings accounts that so many people currently have.

In most cases, these deposits have very short terms. While people will typically maintain accounts for years at a time with a particular bank, the customer reserves the right to withdraw the full amount at any time. Customers have the option to withdraw money upon demand and the balances are fully insured, up to $250,000. Many banks pay no interest at all on checking account balances, or at least pay very little, and pay interest rates for savings accounts that are well below U.S. Treasury bond rates.

Use of Funds

Loans

For most banks, loans are the primary use of their funds and the principal way in which they earn income. Loans are typically made for fixed terms, at fixed rates and are typically secured with real property; often the property that the loan is going to be used to purchase. Some examples of this include loans to start a new business or a construction project.

"Texas Gateway." *Cell Specialization and Differentiation | Texas Gateway*, www.texasgateway.org/resource/133-role-banks.

Stephen D. Simpson, CFA. "The Banking System." *Investopedia*, Investopedia, 30 Mar. 2017, www.investopedia.com/university/banking-system/.

As such, banks play an under-appreciated role in the economy. To some extent, bank loan officers decide which projects, and/or businesses, are worth pursuing and are deserving of capital.

Consumer Lending

Consumer lending makes up the bulk of North American bank lending, and of this, residential mortgages make up by far the largest share. Mortgages are used to buy homes and are typically written for 30-year repayment periods and interest rates may be fixed, adjustable, or variable.

Automobile lending is another significant category of secured lending for many banks. Compared to mortgage lending, auto loans are typically for shorter terms and higher rates. Banks face extensive competition in auto lending from other financial institutions, like captive auto financing operations run by automobile manufacturers and dealers.

As the cost of post-secondary education continues to rise, more and more students find that they have to take out loans to pay for their education. Accordingly, student lending has been a growth market for many banks.

Credit cards are another significant lending type and an interesting case. Credit cards are, in essence, personal lines of credit that can be drawn down at any time. While Visa and MasterCard are well-known names in credit cards, they do not actually underwrite (take risk on) any of the lending. Visa and MasterCard simply run the networks through which money (debits and credits) is moved around between the shopper's bank and the merchant's bank, after a transaction.

"Texas Gateway." *Cell Specialization and Differentiation | Texas Gateway*, www.texasgateway.org/resource/133-role-banks.

Stephen D. Simpson, CFA. "The Banking System." *Investopedia*, Investopedia, 30 Mar. 2017, www.investopedia.com/university/banking-system/.