

BANKING IN AMERICA

OBJECTIVES: *Students will be able to:*

- *Explain why banks today are safe places to deposit money*
- *Explain how banks earn profits*
- *Describe the role of the Federal Reserve*
- *Understand why banks are important to the overall US economy*

VOCABULARY

Credit – A loan; the ability of a person(s) or organization(s) to borrow money

Federal Reserve – The central banking system of the US. The Federal Reserve conducts US monetary policy, supervises, regulates, and provides services to US financial institutions, and is charged with keeping the economy stable in troubled times. The Federal Reserve was established in 1913.

Liquidity – The ability of an asset to be changed into cash quickly without a loss in value.

Monetary Policy – The management of the money supply, interest rates and credit availability by a central bank such as the Federal Reserve to influence the economy.

Sub-prime Mortgage – A mortgage loan to a borrower whose credit, or ability to re-pay the loan, is below average.

CURRICULUM UNIT GUIDE: BANKING

History of US Banking

Before the Revolutionary War, there were no banks in America as we know them today. The first legitimate commercial bank in the US was the Bank of North America, founded in 1781 with the support of Secretary of the Treasury Alexander Hamilton. By 1800 each major US port city had at least one commercial bank serving the local business community. As city banks became accepted, banks spread into smaller cities and towns and expanded their clientele. By the start of the Civil War, when the National Banking Act of 1863 established a uniform national currency, there were more than 1,500 banks.

Prior to the passage of deposit insurance legislation in 1933, there were frequent banking panics, which often led to runs on the banks. In many cases, panicked withdrawal of deposits led to bank failures. When bank failures occurred, depositors often did not get their money back, leading to a period of reduced credit availability, declines in the stock market, temporary factory closings, layoffs and the hoarding of money.

The panic and crisis of 1907, which was finally brought under control with the leadership of JP Morgan, was severe enough to lead to a rethinking of how the nation's banking system should work. The result was the Federal Reserve Act of 1913, which established the Federal Reserve System as the central bank of the US. The Federal Reserve Act called for the creation of an independent central bank to manage the supply of money in response to changes in the economy. It was founded on the belief that flexibility in the financial system would help to stabilize credit and the economy. At the time of its founding, each of the 8-12 reserve banks had a high degree of independence. It was only after the banking crises surrounding the Great Depression that Congress passed the Banking Act of 1935, which, among other things, centralized the Federal Reserve power in Washington, DC.

The Great Depression was the longest, most severe economic downturn in US history, and the frequent banking panics from 1930-1933 were the most severe to ever hit the country. Between 1930 and 1932 more than 2,000 banks failed—more than one-quarter of all US banks. When these banks failed, many people lost some or all of their money. As a result, President Franklin Roosevelt and Congress made several changes. In March, 1933, FDR declared a national bank holiday and spoke to the American people about building trust in the banking system. That June, the Federal Deposit Insurance Corporation (FDIC) was created to provide a federal government guarantee of bank deposits up to a set amount. An important goal of these and other New Deal reforms was to enhance the stability of the banking system. Today's debates on banking policy stem largely from the reforms of the post-Depression era.

In addition to commercial banks, savings and loan banks (S&Ls) are also part of our national banking system. For decades, savings and loans were conservative thrift institutions located in communities across America, whose primary business was taking deposits and making home mortgage loans. In the 1980s, high interest rates, irresponsible lending and other factors caused many S & Ls to fail. Their depositors had to be paid from the guaranteed deposit insurance program and the government took over the S & Ls and sold their assets. By the time this crisis ended, more than 700 S & Ls had failed, and the federal bailout cost taxpayers an extraordinary \$124 billion.

How Banks Work

How do banks work and how do they make money? First, consumers deposit money in a bank. Their money is safe because the FDIC insures deposits up to \$250,000. Banks are required to keep a certain amount on hand for withdrawal by depositors, ranging from 3-10%. The funds available above that requirement are deposited in the bank's account at the Federal Reserve. Depositors have access to the money they have deposited at the bank by going to the bank or ATM machine in person to withdraw cash, by writing a check or by using a debit card, which electronically withdraws money from their account for a purchase. Checks, in some form, have existed for centuries. However today, checks are increasingly being replaced with electronic banking, and it is possible to do all of your banking online. In fact, some banks only accept deposits and make payments online.

Banks use their deposits and excess funds to make loans—mortgages, car loans, student loans, loans to businesses, credit card loans, etc. They charge higher interest on these loans

than the interest they give the depositor, and that difference is how banks make a profit. The exact interest rate charged for a loan is a result of the bank's judgment of its risk—the likelihood the bank will be repaid in full on time. The bank bases its loan interest rate on the state of the local economy, the credit history of the borrower, the length of time to pay back the loan, the size of the loan in relation to income, the size of the loan in relation to the up-front deposit paid, and whether or not real assets, such as a car, back the loan. In addition to loans, banks also make a profit by selling consumer products and services. These can include credit cards, identity theft protection services, foreign exchange services, brokerage services, rewards programs for travel and insurance.

The Federal Reserve System and Banking Regulation

The Federal Reserve System (the “Fed”) is the US central bank and guardian of the nation's money— policy maker, banker, regulator, controller and watchdog all rolled into one. The Fed's mission includes the pursuit of full employment, stable prices and moderate long-term interest rates.

The Fed tries to control the amount of money in circulation in order to fulfill its mission of a stable economy. The Federal Reserve's management of the money supply, interest rates and *credit* availability is called “*monetary policy*.” The governing policy group of the Federal Reserve—called the Federal Open Market Committee-- meets about every six weeks to evaluate the economy and then set monetary policy. Each time they meet, they issue a statement indicating whether they view inflation or economic weakness as the greater danger, and signaling their view for future interest rates. This statement is closely watched by bankers and investors, and often affects the bond and stock markets.

How does the Fed control the supply of money? Each day, the New York Fed buys or sells government securities, thereby adding or withdrawing money from the system. The Fed also sets the requirements and financial benefits for banks' reserves held by the Fed. The Fed supervises banks' businesses and risks daily, and then uses that information to help make decisions about monetary policy. One of the Fed's key roles is to influence banks' *liquidity*, or ability to turn assets into cash quickly without a loss in value. The Fed provides liquidity to commercial banks by lending them money and acting as the lender of last resort during a crisis. Banks need liquidity to make loans, and without bank loans, or credit, to businesses and consumers, our economy grinds to a halt.

DISCUSSION QUESTIONS

1. How have bank panics in the past influenced the safety of banks today?
2. Would you rather bank using checks or pay your bills online? Why?
3. How do banks make a profit?
4. How does the Federal Reserve make and implement monetary policy?
5. Why is it important to the economy for banks to make loans (extend credit) to consumers?

CLASSROOM ACTIVITY

This exercise can be done with students working in small groups and then reporting back to the whole class.

Students are going to play the role of banker at a time when interest rates are higher than they are today. The bank's interest rate for deposits into savings accounts is currently 3.0%. All of the people below come into your bank asking for a loan as described. List the interest rate you would charge each of them for the loan they want and explain your decisions:

_____ A first-time home buyer who intends to live in her home, who has held her teaching job for the past five years, and who has paid off her student loan. She wants a 30-year mortgage loan for \$400,000.

_____ A divorced father who has a questionable credit history, was unemployed until six months ago, and who wants a 30-year *subprime mortgage* for \$300,000.

_____ A teenager who wants to take out a credit card with a limit of \$500 to establish a credit history so he can qualify for a college loan in two years. He does not have a bank account and has never had a loan before.

_____ The owner of a small advertising business with two employees and 20 clients and earnings of \$250,000 per year for the last two years. He wants a 5 year loan for \$750,000 to expand his business into the neighboring state.

_____ A retired couple who want a five year car loan to cover 75% of the purchase of a new automobile after trading in their old car. They have a proven credit history and are owners of their home who have paid off their mortgage in full.

_____ A two-year-old doctors' office with a staff of 10 doctors who want a three year loan of \$1.5 million to purchase two pieces of MRI scanning equipment for their office.

_____ The Dormitory Authority of NY State which wants a 20-year loan for \$5 million to build student housing near a public college in Binghamton, NY.

_____ A large German special materials manufacturer with operations around the globe who wants a 10 year loan for \$10 million to build a factory near the city of the bank's headquarters. The company is profitable, their stock trades publicly on the NYSE, and their only competitors are in Japan and France.