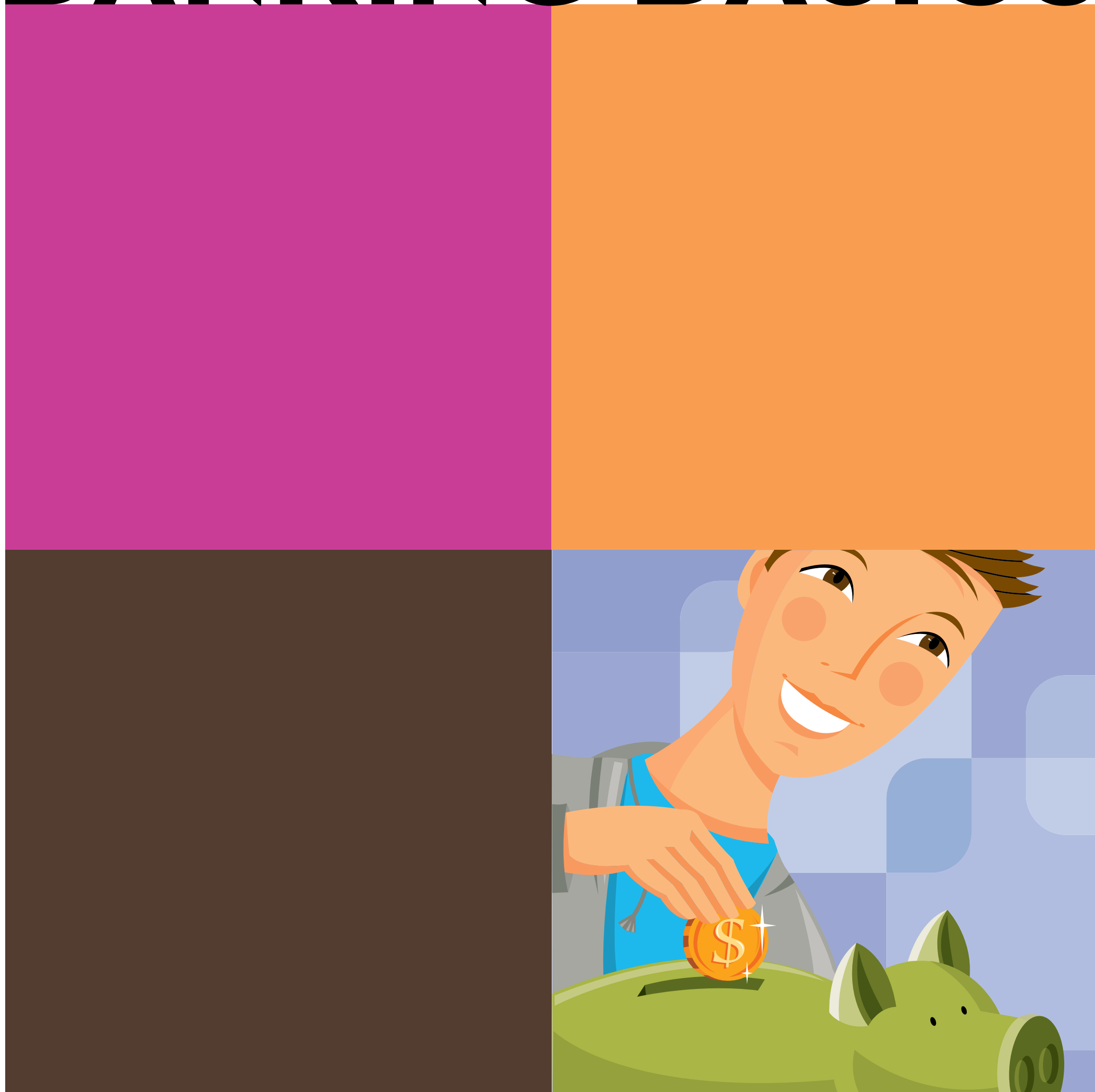
Banking Basics



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Introduction

Some young savers stash their cash in shoe boxes or jelly jars. Others use "piggy banks," which today look more like spaceships or cartoon characters.

In any case, the same problem arises. Sooner or later, the piggy bank or jelly jar fills up, and you have to make a decision: Should I spend the money or continue to save? And if I continue to save, should I open a bank account or just find a bigger jar?

Maybe you've had to face such a decision yourself. If you decide to keep your money at home, it will just sit there and won't earn any extra money for you. You also run the risk that a burglar, a fire, or some other disaster will wipe out your savings in the wink of an eye.

Then again, if you open a bank account, you can't "visit" your money as easily as you can when it sits in your dresser drawer. You can't just walk into a bank in the middle of the night to count your cash. You can't run the coins through your fingers or toss the bills in the air and let them rain down on your head.

Opening a bank account is a big step because you are putting your money in someone else's hands. You're counting on someone else to handle your money responsibly. Before you do that, it might be a good idea to understand how banks operate.

That's the purpose of this pamphlet. It won't tell you everything there is to know about banks and banking, but we hope it will be a good basic introduction.

What is a bank?

A bank is a business. But unlike some businesses, banks don't manufacture products or extract natural resources from the earth. Banks sell financial services such as car loans, home mortgage loans, business loans, checking accounts, credit card services, certificates of deposit, and individual retirement accounts.

Some people go to banks in search of a safe place to keep their money. Others are seeking to borrow money to buy a house or a car, start a business, expand a farm, pay for college, or do other things that require borrowing money.

Where do banks get the money to lend? They get it from people who open accounts. Banks act as go-betweens for people who save and people who want to borrow. If savers didn't put their money in banks, the banks would have little or no money to lend.

Your savings are combined with the savings of others to form a big pool of money, and the bank uses that money to make loans. The money doesn't belong to the bank's president, board of directors, or stockholders. It belongs to you and the other depositors. That's why bankers have a special obligation not to take big risks when they make loans.

How do people start banks?

The process of starting a bank varies from state to state, but, in general, here's how it goes:

1. A group of individuals decides to start a bank. Their first step is to apply for a charter from their state banking commission.* The charter sets out the rules for how they must operate their bank.

2. The banking commission reviews the application to make sure it is complete and then schedules a hearing.

3. The commission looks at the financial condition and the character of the applicants.

4. After that, the banking commission will either approve the application or deny it.

5. If approved, the group that applied to start the bank will then have a certain amount of time to raise the necessary capital, put together a full management team, and obtain federal deposit insurance.

6. When that's done, the group will notify the banking commission, which will then review the list of proposed investors. If the commission has no objection to the list, if the bank is insured, and if an acceptable management team is in place, the commission will issue its final approval and the bank may open for business.

*** The United States has a dual banking system. People who want to start a bank can choose to apply for either a state charter or a charter from the federal government.**

How did banking begin?

Imagine for a moment that you are a merchant in ancient Greece or Phoenicia. You make your living by sailing to distant ports with boatloads of olive oil and spices. If all goes well, you will be paid for your cargo when you reach your destination, but before you set sail you need money to outfit your ship. And you find it by seeking out people who have extra money sitting idle. They agree to put up the money for your voyage in exchange for a share of your profits when you return . . . if you return.

The people with the extra money are among the world's first lenders, and you are among the world's first borrowers. You complain that they're demanding too large a share of the profits. They reply that your voyage is perilous, and they run a risk of losing their entire investment. Lenders and borrowers have carried on this debate ever since.

Today, people usually borrow from banks rather than wealthy individuals. But one thing hasn't changed: Lenders don't let you have their money for nothing.

Lenders have no guarantee that they will get their money back. So why do they take the risk? Because lending presents an opportunity to make even more money.

For example, if a bank lends $50,000 to a borrower, it is not satisfied just to get its $50,000 back. In order to make a profit, the bank charges interest on the loan. Interest is the price borrowers pay for using someone else's money. If a loan seems risky, the lender will charge more interest to offset the risk. (If you take a bigger chance, you want a bigger pay-off.)

But the opportunity to earn lots of interest won't count for much if a borrower fails to repay a loan. That's why banks sometimes refuse to make loans that seem too risky. Before lending you money, they look at:

- how much and what types of credit you use, such as credit cards, auto loans, or other consumer loans;
- whether or not you have a history of repaying your loans, and
- how promptly you pay your bills.

Banks also use interest to attract savers. After all, if you have extra money you don't have to put it in the bank. You have lots of other choices:

- You can bury it in the backyard or stuff it in a mattress. But if you do that, the money will just sit there. It won't increase in value, and it won't earn interest.
- You can buy land or invest in real estate. But if the real estate market weakens, buildings and land can take a long time to sell. And there's always the risk that real estate will drop in value.
- You can invest in the stock market. But like real estate, stocks can also drop in value, and the share price might be low when you need to sell.
- You can buy gold or invest in collectibles such as baseball cards, but gold and collectibles fluctuate in value. Who knows what the value will be when it's time to sell? (In 1980, gold sold for $800 an ounce. By1983, the price had sunk below $400.)

Or you can put the money in a bank, where it will be safe and earn interest. Many types of bank accounts also offer quick access to your money.

Interest is the price borrowers pay for using someone else's money.

Why are there so many different types of banks?

Not all banks are exactly the same. There are commercial banks, savings banks, savings and loan associations (S&Ls), cooperative banks, and credit unions. Today they offer many of the same services, but at one time, they were very different from one another.

Commercial banks originally concentrated on meeting the needs of businesses. They served as places where a business could safely deposit its funds or borrow money when necessary. Many commercial banks also made loans and offered accounts to individuals, but they put most of their effort into serving business (commercial) customers.

Savings banks, S&Ls, cooperative banks, and **credit unions** are classified as thrift institutions or "thrifts," rather than banks. Originally, they concentrated on serving people whose banking needs were ignored or unmet by commercial banks.

The first **savings banks** were founded in the early 1800s to give blue-collar workers, clerks, and domestic workers a secure place to save for a "rainy day." They were started by public-spirited citizens who wanted to encourage efforts at saving among people who did not earn much money.

Savings and loan associations and **cooperative banks** were established during the 1800s to help factory workers and other wage earners become homeowners. S&Ls accepted savings deposits and used the money to make loans to home buyers. Most of the loans went to people who did not make enough money to be welcome at traditional banks.

Credit unions began as a 19th-century solution to the emergency needs of people who were unable to borrow money from traditional lenders. Before the opening of credit unions, ordinary citizens had no place to turn when they faced unexpected home repairs, medical expenses, or other emergencies. Credit unions were started by people who shared a common bond such as working in the same factory, belonging to the same house of worship, or farming in the same community. Members pooled their savings and used the money to make small loans to one another.

Although there are still differences between banks and thrifts, they now offer many of the same banking services to their customers. Most commercial banks now compete to make car loans. Many thrift institutions have begun to make commercial loans, and some credit unions make loans to home buyers.

Credit unions were started by people who shared a common bond. Members pooled their savings and used the money to make small loans to one another.

How do I choose a bank?

Back in the 1950s, banks often gave away toasters to new depositors, and that made choosing a bank simpler. You went to the one that gave away the best toaster.

Today banks rarely give away toasters, and choosing a bank is a little more complicated. For starters, you should shop around to find out which banks offer the best services and the lowest fees. Some banks charge a monthly fee if your account falls below a certain level, and that fee can be higher than the interest your account earns. Other banks may charge fees for many types of transactions. You don't want that.

In certain states, such as Massachusetts, the law prohibits banks from charging fees on savings accounts held by people under the age of 18 or over the age of 65. Find out if your state has such a law.

Other things you might want to consider:

1. Does your bank pay depositors a competitive interest rate?

2. Is the bank in a convenient location and are its business hours convenient for you?

3. Is your deposit insured by the FDIC (Federal Deposit Insurance Corporation)?

4. Is the bank a good corporate citizen? Does it invest in your neighborhood?

5. And last, but certainly not least, does your bank provide courteous and efficient service?

Before you open an account, ask a few people if they are happy with their bank. And do some comparison shopping because all banks are not the same.

What types of accounts do banks offer?

People use banks for different purposes. Some have extra money to save; others need to borrow. Some need to manage their household finances; others need to manage a business. Banks help their customers meet those needs by offering a variety of accounts.

Savings accounts are for people who want to keep their money in a safe place and earn interest at the same time. You don't need a lot of money to open a savings account, and you can withdraw your money easily.

Certificates of deposit (CDs) are savings deposits that require you to keep a certain amount of money in the bank for a fixed period of time (example: $1,000 for two years). As a rule, you earn a higher rate of interest if you agree to keep your money on deposit longer, and there is usually a penalty if you withdraw your money early.

Individual retirement accounts (IRAs) are savings deposits that offer an excellent way to save for your later years. You don't have to pay tax on the money you deposit in your IRA until you withdraw it. But there is often a significant penalty if you withdraw your funds before you reach a specified age (usually 59 or older).

Checking accounts offer safety and convenience. You keep your money in the account and write a check when you want to pay a bill or transfer some of your money to someone else. If your checkbook is lost or stolen, all you need to do is close your account and open a new one so that nobody can use your old checks. (When cash is lost or stolen, you rarely see it again.) Another attractive feature of a checking account is that your bank sends you a monthly record of the checks you have written, and you can use that record if ever need to prove that you've made a payment. Banks sometimes charge a fee for checking accounts, because check processing is costly.

Many banks also offer no-fee checking and checking accounts that earn interest if you agree to keep a certain amount of money—a minimum balance—in the account. But these accounts are limited to non-business customers. Banking laws almost always require businesses to use regular checking accounts that do not pay interest.

Money market deposit accounts are similar to checking accounts that earn interest, except that they usually pay a higher rate of interest and require a higher minimum balance (often $2,500 or more). They also limit the number of checks you can write per month.

Finally, banks do not always call their accounts by the same names. Often, they choose distinctive names in hopes of attracting customers. But there can be a real difference between one bank's accounts and another's, so shop around.

BANKS SOMETIMES CHARGE A FEE FOR CHECKING ACCOUNTS, BECAUSE CHECK PROCESSING IS COSTLY.

Is it difficult to open a bank account?

You've finally decided to take the plunge. With your cash tucked deep in your pocket, you walk into the bank and ask to open a savings account.

The bank's receptionist directs you to a desk where a customer service representative will help you with the paperwork. To your surprise, the only form you need to fill out is a signature card, which requires you to sign your name and then print your name, address, telephone number, date of birth, social security number, and your mother's maiden name (as a means of further identification). After you complete the signature card, you receive a bank book (sometimes called a passbook) that lists your account balance (the total amount of money in your account).

Whenever you make a deposit (put money in) or a withdrawal (take money out), the transaction is recorded in your bank book. It is very important for you to keep track of the activity in your account.

You don't need lots of money to start a savings account. Some banks let you open one with as little as $20. Nor do you need to wait until you are 18 years old. In most cases, you can open a savings account as soon as you are old enough to sign your name, or even earlier than that if you open the account with a parent or guardian.

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