Banks and Banking

The principal types of banking in the modern industrial world are *commercial banking* and *central banking*.

A commercial banker is a dealer in money and in substitutes for money, such as checks or bills of exchange.

The banks of the banking business is borrowing from individuals (firms and occasionally governments)- receiving “deposits” from them. With these resources and also with the bank’s own capital, the banker makes loans or extends credit and also invests in securities. The banker makes profit by borrowing at an rate of interest and lending at a higher rate and by charging commissions for services rendered.

A bank must always have cash balances on hand in order to pay its depositors upon demand or when the amounts credited to them become due. It must also keep a proportion of its assets in form that can readily be converted into cash. Only in this way can confidence in the banking system be maintained. Provided it honours its promises, a bank can create credit for use by its customers by issuing additional notes or by making new loans which in their turn become new deposits. The amount of credit may considerably exceed the sums available to it in cash, but the bank is able to do this, only as long as the public believes the bank can and will honour its obligations. The claims against the bank can be transferred by means of checks or other negotiable instruments from one party to another.

These are the essentials of deposit banking as practiced throughout the world today, with the partial exception of socialist-type institutions.

Another type of banking is carried out by central banks, bankers to governments and “lenders of last resort” to commercial banks and other financial institutions. They are often responsible for formulating and implementing monetary and credit policies, usually in cooperation with the government.

In some cases, the US Federal Reserve System have been established specifically to lead or regulate the banking system; the Bank of England have come to perform these functions through a process of evolution.

Finance companies, savings banks, investments banks, trust companies are often called banks, but they don’t perform the banking functions described and are only financial intermediaries, cannot create money, they can lend no more than savers place with them.

I The development of banking system

Banking is known about it prior to the 13th century.

Early “banks” dealt primarily in coin and bullion, their business being money changing and the supplying of foreign and domestic coin. Another group of banking institutions was the merchant bankers, who dealt in goods and in bills of exchange, providing for the remittance of money at distance through one of its agents elsewhere.

Another form of early banking activity was the acceptance of deposits based on oral agreement between the parties whereby the customer would be allowed to overdraw his account.

In the 17th century, English bankers begun to develop a deposit banking business. They dealt in bullion and foreign exchange, acquiring and sorting coin for profit. As a means of attracting coin for sorting, they were prepared to pay a rate of interest.

About the same time, a practice grew up, whereby a customer could arrange for the transfer of part of his credit balance to another party by addressing an order to the banker. This was the origin of modern check. It was only a short step from making a loan in specie or coin, to allowing customers to borrow by check. The customer could overdraw his account at once or up to a specified limit. In the first case, interest was charged on the full amount of the debit, and in the second, the customer paid interest only on the amount actually borrowed.

Another way in which a bank could create claims against itself was by issuing bank notes. The amount depended on the banker's judgement of the possible demand for specie. The first bank notes issued in Europe were by the Bank of Stockholm in 1661. Nowadays, in most countries the issue of bank-notes has become a prerogative of the Central Bank.

When the check proved to be a convenient mean of payment and the public begun to use check for the larger part of their monetary transactions, banks begun to grant the drawing of checks much in excess of the amount of cash hold, in this way "creating money", claims that were generally accepted as means of payment. Such money come to be known as "bank money" or "credit". When a check is drawn, a loan is created but usually every loan so made tends to return to the banking system as a deposit, and so deposits tend to increase for the system as a whole to about the same extent as loans.

The check was defined as a bill of exchange and the early legal recognition of the negotiability of credit instruments. Bill of exchange was one of the most important factors in the development of banking in England.

On the other hand, in continental Europe, limitations on the negotiability of an order of payment presented the extention of deposit banking based on check. Continental countries developed their own system, known as giro payments, whereby transfers were effected on the basis of written instructions to debit the account of the payer and to credit that of the payee.

II The business of banking

The business of banking consists of borrowing and lending. As in other businesses, operations must be based on capital, but banks employ comparatively little of their own capital in relation to the total volume of their transactions. The purpose of capital and reserve accounts is primarily to provide an ultimate cover against losses on loans and instruments. In the United States, capital accounts also have a legal significance, since the laws limit the proportion of its capital, a bank may lend to a single borrower. Similar arrangements exit elsewhere.

FUNCTIONS OF COMMERCIAL BANKS

A bank's main liabilities are its capital, including reserves and subordinated debt, and deposits. The latter may be from domestic or foreign sources (corporations, firms, private individuals, other banks and even governments). They may be repayable on demand(sight deposits or current accounts) or repayable only after the lapse of a period of time (time, term or fixed deposits and saving deposits).

A bank's assets include:

- Cash in the form of credit balances with other banks, usually with a central bank
- Liquid assets- money at call and short notice, day-to-day money, short term government paper, commercial bill of exchange; all can be converted readily into cash without risk of substantial lost
- Instruments of securities- medium term and longer term government securities including those of local authorities and in some countries shares in industrial concerns
- Loans and advances made to customers of all kinds
- The bank's premises, furniture and fitings

All bank balance sheets must include an item that relates to contingent liabilities exactly balanced by an item to the other side of the balance sheet representing the customer's obligations to indemnity the bank.

Deposits

The bulk of the resources employed by a modern bank consists of borrowed money (that is, deposits) which is lent out as profitably as is consistent with safety. Insofar, as an increase in deposits provides a bank with additional cash; the increase in cash supplements its loanable resources and permits a more than proportionate increase in its loans.

An increase in deposits may arise in two ways:

1. When a bank makes a loan, it may transfer the sum to a current account, thus directly creating a new deposit; or it may arrange a line of credit for the borrower upon which he will be permitted to draw checks which were deposited by third parties, likewise create new deposits
2. An enlargement of government expenditure financed by the Central Bank may occasion a growth in deposits, since claims on the government will be paid into the commercial banks as deposits

Taking one bank in isolation, an increase in its loans may result in a direct increase in deposits, that is an increase in the potential liability to pay out cash. It is in this way that an increase in deposits usually provides the basis for further bank lending.

From time to time, any individual bank may experience market fluctuations in its deposit totals and all the banks in a country may be subject to seasonal variations.

In banking, confidence on the part of the depositors is the true basis of stability. Confidence is steadier if there exists a central bank to act as a “lender of last resort”. Another means of maintaining confidence employed in some countries is deposit insurance, which protects the small depositor against loss in the event of a bank failure.

Reserves

Since the banker undertakes to provide depositors with cash on demand or upon prior notice, it is necessary to hold a cash reserve and to maintain a “safe” ratio of cash to deposits. The safe ratio is determined largely through experience. It may be established by convention or by statute. If a minimum cash ratio is required by law, a proportion of a bank’s assets is in effect frozen and not available to meet sudden demands for cash from the banks’ customers. No banker can safely ignore this. Unless a bank held cash covering 100% of its demand deposits, it could not meet the claims of depositors if they were all to exercise in full and at the same time their rights to demand cash. If that were a common phenomenon, deposit banking could not longer survive.

A bank may mobilize its assets in several ways. It may demand repayment of loans, immediately or at short notice; it may sell securities or it may borrow from the Central Bank, usong paper representing investments or loans as security.

But banks must either maintain their cash reserves and other liquid assets at a higher level or have access to a “lender of last resort” such as a central bank, able and willing to provide cash against the security of eligible assets because calling in loans or selling marketable assets would disrupt the delicate debtor-creditor relationship.

INDUSTRIAL FINANCE

Long term and medium term lending

Banks that do a great deal of long-term lending to industry must ensure their liquidity by maintaining relatively large capital funds and a relatively high proportion of long-term borrowings.

Such banks have developed special means of reducing their degree of risk. Every instrument is preceded by a thorough technical and financial investigation. The initial advance may be an interim credit, later converted into a participation.

A bank may be obliged to hold such shares for long periods before being able to liquidate them. They often retain an interest in a term as an ordinary investment as well as to ensure a degree of continuing control over it.

The long-term position of industrial finance in Britain and the Commonwealth countries is usually handled by specialist institutions, with the commercial banks providing only part of the necessary capital. In Japan the long-term financial needs of industry are met partly by special industrial banks and partly by the ordinary commercial banks. In Germany the commercial banks customarily handle long-term finance.

Since World War II the commercial banks in United States have developed the term loan, especially for financing industrial capital requirements, and it was popularized in the economic depression of the 1930.

Most term loans have an effective maturity of 5 years, though sum runs for 10 years.

Short-term loans

They are the core of the banking business. It consists in the provision of working capital but the banks also provide temporary finance for fixed capital development, aiding a customer until long-term finance can be found elsewhere.

Much of this short-term lending is done by overdraft. This one permits a depositor to overdraw an account up to an agreed limit. Often, overdrafts are allowed to run indefinitely subject to a periodic review. An advance is reduced or repaid whenever the account is credited with deposits and recreated when new checks are drawn upon it, interest being paid only on the amount outstanding.

An alternative method of short-term method of lending is to debit a loan account with the amount borrowed, crediting the proceeds to a current count; interest is usually payable on the whole amount of the loan, which normally is for a fixed period of time.

In a number of countries, including United States, the United Kingdom, France, Germany and Japan, short-term finance is often made available on the basis of discountable paper commercial bills or promissory notes. Some of these papers are usually rediscountable at the Central Bank, thus becoming virtually a liquid asset, unlike a bank advance or loan.

Credit may be offered with or without formal security depending on the reputation and financial strength of the borrower. In many countries, a customer may use a number of banks, and these institutions usually freely exchange information about joint credit risks. In Britain and the Netherlands, however most concern tend to use a single banking institution for most of their needs.

THE PRINCIPLES OF CENTRAL BANKING

The principles of central banking grew up in response to the recurrent British financial crises of the 19th century and were later adopted in other countries.

The expansion or contraction of the money supply to which banks contribute may be excessive, this raising the need for a desinterested outside authority able to view economic and financial developments objectively and to exert some measure of control over the activities of the banks.

Responsibilities of central banks

The first concern of a central bank is the maintenance of a strongly based commercial banking structure. It must also cooperate closely with the national government.

Relationships with commercial banks

One source of economic instability is the supply of money. If banks expand credit to such an extent that inflationary pressures develops, a period of undue caution in the making of loans follows inevitably and sometimes even financial crisis and bank failures. Such crises threaten the existence of financial institutions.

So, the willingness of a central bank to offer support to the commercial banks and other financial institutions in time of crises was greatly encouraged by the gradual disappear and of weaker institutions and a general improvement in bank management.

Banks also become more experienced in the evaluation of risks and in some cases the central bank educates commercial banks in the canons of sound finance. For example, in the United States, the Federal Reserve System examines the books of the commercial banks and carries on a range of frankly educational activities.

The most obvious danger to the banks is a sudden and overwhelming run of their cash resources in convergence of their liability to depositors to pay on demand.

In the ordinary course of business, the demand for cash is fairly constant or subject to seasonal fluctuations that can be foreseen.

The central bank protects banks from the consequences of a sudden demand for cash. For doing this, the central bank is permitted to buy the assets of commercial banks or to make advances against them. It has also the power to issue money acceptable to bank depositors.

Because a central bank plays this role with respect to commercial banks, it is allowed to exercise a degree of control over the way in which the banks conduct their business.

So, most central banks now take a continuing day-to-day part in the operations of the banking system.

The evolution of those working relations among banks implies a community of outlook that in some countries is relatively recent. The concept of a central bank responsible for the stability of the banking system supposes mutual confidence and cooperation. That’s why contact between the central bank and the commercial banks must be close and continuous.

Once a central bank formulated its policy, the commercial banks must accept its leadership, otherwise the whole basis of central banking would be undetermined.

The central bank and the national economy

Since the number of modern economies is self contained, central banks must give considerable attention to trading and financial relationships with other countries, so there is a permanent demand for foreign and home currency.

Sometimes, there is a surplus of purchases and sometimes a surplus of sales. Short-period disequilibrium don’t matter, but it is rather important that there be a tendency to balance over a longer period since a country can be a permanent borrower or to continue building up a command over goods and services that it does not exercise.

Short period disequilibrium can be met very simply by diminishing or building up balances of foreign exchange. If a country has no balances to diminish, it may borrow but normally, at least carries working balances. If the commercial banks find unprofitable to hold such balances, the Central Bank is available to carry them.

Long-period equilibrium is more difficult to achieve. It may be approached in 3 different ways: price movements, exchange revaluation or exchange controls. For stimulate imports, the monetary authorities can induce a relative rise in home prices by encouraging an expansion of credit. If additional exports are necessary the authorities can attempt to force down cost at home by operating to restrict credit.

The objective may be achieved more directly by revaluing a country’s exchange rate. If the rate is appreciated, exports become more expensive for foreigners to buy and if the rate is depreciated the prices of export goods in the world's markets are lower. In both cases, the effect is likely to be temporary, so the authorities often prefer relative stability in exchange rates.

Quite often, governments have resorted to exchange controls to allocate foreign exchange more or less directly in payment for specific imports. The system has proved reasonably efficient in achieving balance on external payments account. Its chief disadvantage is that it interferes with normal market processes, thereby encouraging rigidities in the economy, reinforcing vested interests and restricting the growth of world trade.

Whatever method is chosen, the Central Bank or a institution closely associated with it supervise the process to ensure that proper responses are made to changing conditions.

Economic fluctuation

Because monetary influences is an important contributory factor in economic fluctuations the Central Bank has the responsibility to regulate the amount of lending by banks and it may even influence in some degree the direction of lending as well as the amount.

A greater responsibility of the Central Bank is that of taking measures to prevent or overcome a slump.

For the Central Bank to be effective in regulating the volume and distribution of credit so that economic fluctuation may be damped, if not eliminated, it must at least be able to regulate commercial bank liquidities.

The United States and a growing number of Western European countries have adopted the practice of setting growth targets for the money supply and sometimes other monetary targets as well, usually setting some range of allowable variation.

It is incorrect to suppose, however, that the actions of the Central Bank can achieve a high degree of stability; this degree depends on the provision of an appropriate fiscal environment.

Banking services

Another responsibility of the Central Bank is to ensure that banking services are adequately supplied to all members of the community that need them. Some areas of a country may be "under-banked" and central banks have attempted, directly or indirectly, to meet such needs.

A different sort of problem arises when the business methods of existing banks are in satisfactory. In such circumstances, a system of bank inspection and audit organized by the central banking authorities or of bank "examinations" may be the appropriate answer (France's Banking Control).

In developing countries, central banks may encourage the establishment and growth of specialist institutions such as savings institutions and agricultural credit or industrial finance corporations. These serve to improve the mechanism for tapping existing liquid resources and to supplement the flow of funds for investment in specific fields.

THE STRUCTURE OF MODERN BANKING SYSTEMS

The banking systems of the world have many similarities, but they also differ, sometimes in quite material respects. The principal differences are in the details of organization and technique. The differences are gradually becoming less pronounced because of the tendency in each country to emulate practices that have been successful elsewhere.