Understanding Banking

A bank is an institution that accepts customer deposits and offers loans to individuals and corporate clients.

Banks make money by charging higher interest on loans than the interest they pay on customer deposits.

In the United States, banks are required to retain 10% of the customer deposits as reserves, while using the other 90% to provide loans.

Banking Fundamentals – How the Banking Industry Works

In the United States, banks are regulated by the Federal Reserve. Banks must retain at least 10% of each deposit on hand but can lend out the other 90% as loans. The reserve requirement applies to all types of banks that are licensed to operate in the United States, and they can hold the reserve as a deposit in the local Fed bank or as cash in the vault.

The actual reserve requirement is determined by the Federal Reserve Board of Governors. When the Fed reduces the reserve requirement for member banks, it is implementing an expansionary monetary policy, which increases the amount of money in the economy. On the other hand, when it increases the reserve requirement, it is implementing a contractionary monetary policy that reduces liquidity.

All the Fed's member banks must be insured with the Federal Deposit Insurance Corporation (FDIC). The FDIC was created in 1933 after the Great Depression through the enactment of the Glass-Steagall Act. It came after multiple bank failures that resulted in banking panics, with depositors demanding all their deposits held at the bank.

The FDIC was formed to prevent such occurrences by insuring all deposits that customers keep at the bank. It insures savings accounts, checking accounts, and other deposit accounts. During the 2008 Global Financial Crisis, the FDIC raised the deposit limit to $250,000 per account to protect depositors from the crisis.

Banking Fundamentals – Types of Bank Accounts

The common types of bank accounts include:

1. Savings account

A savings account is a bank account that a customer can deposit money in that they do not need right away, but that is available for withdrawal whenever needed. The bank loans out the money to borrowers and charges interest on the amount of credit disbursed.

2. Checking account

A checking account allows customers to access their deposited funds with ease, and they can use it to make their financial transactions such as paying bills. A customer can access the funds by writing a check, using a debit card to withdraw money or make payments, or by setting up automatic transfers to another account.

3. Certificate of deposit

A certificate of deposit is a bank account that holds a fixed amount of money for a defined period of time such as six months, one year, two years, etc. It pays a fixed interest rate on the amount held.

Banking Fundamentals – Types of Banks

Below are the most common types of banks in the United States:

1. Commercial banks

Commercial banks are the most common type of bank. They provide various services such as providing business loans, accepting deposits, and offering basic investment products to both individuals and private businesses.

Commercial banks also offer other financial services such as global trade services, merchant services, insurance products, retirement products, and treasury services. They make money by providing business loans to individual and corporate borrowers and earning interest income from them, and also by charging service fees.

2. Credit unions

A credit union is a type of bank that is open to a specific category of people who are eligible for membership. It is member-owned and is operated by the members on the basis of people helping people. Traditionally, credit unions served either residents of a local community, members of a church, employees of a specific company or school, etc.

The ownership structure of credit unions allows them to offer more personalized and lower-cost banking services to their members. Due to their small operating size, credit unions may pay higher interest rates than banks, and customers can build a better relationship with the banking staff. On the downside, the credit unions' operations are limited, and the customer's deposits are less accessible.

3. Investment banks

Investment banks are banks that provide corporate clients access to the capital markets to raise funds for expansion. They help companies raise funds in the stock market and bond market to finance their expansion, acquisitions, or other financial plans. They also facilitate mergers and acquisitions by identifying viable companies for acquisition that meet the buyer's criteria.

Investment banks make money by offering advisory services to corporate clients, trading in the financial markets, and representing clients in mergers and acquisitions. Some examples of large investment banks in the U.S. include Merrill Lynch, Goldman Sachs, J.P. Morgan, and Bank of America.

Here are some commonly used banking terms you should know to be better informed about your financial life.

Glossary of Basic Banking Terms

Account. A type of financial property or financial obligation that is held and owned under your name. When you open a financial account—whether it's a checking account, savings account, CD or money market account—you have certain rights and responsibilities as an account holder.

ACH (Automated Clearing House). ACH is a type of electronic funds transfer system that operates between banks, businesses and individual consumers in a nationwide network. Banks use ACH payments to move money between them. When you sign up for direct deposit of your paycheck at work, that money often moves into your bank account via ACH.

APR (Annual Percentage Rate). The total annualized cost of a loan. When you borrow money, whether it's via a credit card, car loan or another loan, the lender is required to disclose the APR, so you understand the full cost of borrowing the money.

APY (Annual Percentage Yield). The annual yield earned on a deposit account, such as a savings, money market or CD account. Savers can use APY as one of several factors to help determine which savings options are the best.

ATM (Automated Teller Machine). A convenient location for basic banking transactions, such as withdrawing cash, depositing checks or making balance inquiries. Many banks offer access to a network of fee-free ATMs.

Available balance. The amount of money you have in your bank account that is available to spend or withdraw. If you have recently deposited a check or made purchases, those transactions may still be marked as pending and may not be included in your available balance.

Cash equivalents. Highly liquid accounts holding funds that can be accessed immediately without penalty or risk of loss. Savings accounts, checking accounts and money market accounts insured by the FDIC (Federal Deposit Insurance Corporation) at banks and the NCUA (National Credit Union Administration) at credit unions are generally considered safe, liquid accounts to hold your cash.

Certificate of deposit (CD). A type of time deposit account, generally insured by the FDIC at banks and the NCUA at credit unions, where customers can put their savings to earn a yield. There are many types of CDs, but most require that you lock up your money for a minimum term, such as six months or one year. The APY that you can earn on a CD depends on the bank, the term and other factors.

Check. A type of financial instrument that instructs the check writer’s bank to make a payment to the recipient indicated on the check. Some people write paper checks and other people use their bank’s online bill pay feature to issue electronically generated checks.

Checking account. Your checking account, sometimes referred to simply as a bank account, is your home base for making financial transactions. The account can be interest-bearing, or non-interest-bearing, depending on the bank or credit union.

Compound interest. When you save money in an interest-earning account, such as a savings account or CD, compound interest is the powerful financial effect that helps your savings grow over time. With compound interest, your savings multiply over time by earning interest on top of the principal plus interest, year after year.

Conditions. Also known as terms and conditions, this is the fine print of a bank account or loan agreement. Make sure you read and understand the implications of your financial accounts and obligations.

Credit/credit history/credit score. Credit generally refers to your ability to borrow—the willingness of banks and other lenders to extend a loan to you. If you have a strong credit history, that means you have a proven track record of paying bills on time and paying your debts. Your credit score is a measure of creditworthiness based, in part, on your credit history. Having a higher credit score can help you qualify for a lower interest on loans, better credit terms, larger loan amounts and higher credit limits.

Debit card. This is a payment method that's connected to your checking account. Debit cards work similarly to credit cards and can be accepted at the same points of sale, but the money that you spend gets deducted from your checking account balance.

Direct deposit. A payment method where people can sign up to have paychecks automatically deposited into their account, without having to endorse and deposit a check. Many banks offer reduced fees to customers who have recurring direct deposits.

Electronic funds transfer (EFT). A method of transferring funds between banks, businesses or individual people. Two types of EFT are the automated clearing house (ACH) network and wire transfers.

Electronic signatures. Under U.S. federal law, electronic signatures or e-signatures have the same legal validity as signatures on paper contracts. Online contracts may have the same legal status as paper contracts.

Endorsement. To cash or deposit a check, you must sign your name on the back. This is known as an endorsement.

Federal Deposit Insurance Corporation (FDIC). The FDIC is a federal government agency that helps ensure the stability of the U.S. financial system and protects bank customers. If you deposit your money into an FDIC-insured bank account, your money is protected up to $250,000 per depositor, for each account ownership category, in the event of a bank failure.

Fraudulent charges. Many banks have strong protections against fraudulent transactions. If a suspicious transaction occurs on your account, your bank may prevent the payment from going through until they talk with you to confirm that the purchase is valid.

Grace period. A certain amount of time when a borrower can delay making a payment on a loan or credit card account without paying a penalty or incurring interest charges. It can also refer to the period after the maturity date of a certificate of deposit when you can withdraw funds without penalty.

Investments. Investments are financial assets that are purchased and sold by investors, with the goal of earning a return on investment (ROI). Common types of investments include stocks, bonds, mutual funds, index funds, exchange traded funds and real estate. There are also various alternative investments like gold, commodities, fine art, wine and more. Unlike bank savings and checking accounts, investments are not FDIC insured and have a risk of loss.

Joint account. An account with two or more owners that own the account equally, with the same rights and obligations of using the account. For example, many married couples have a joint checking account that allows them both to write checks and make deposits into the same shared account.

Maturity date. This is the date of expiration for the contractual obligation of a financial instrument. For example, certificates of deposit have a maturity date that depends on the length of the CD term. When the CD matures, you have the option to withdraw the money. Some banks and credit unions also allow you to roll it into a new CD or enable the CD to renew automatically.

Money market account. A type of FDIC-insured deposit account that generally pays interest. Money market accounts tend to have higher minimum balance requirements than a typical savings account. While it is a type of savings deposit, a money market account also may offer features usually found with a checking account, such as a debit card or check-writing privileges.

Online bank. Online banks, also called digital or internet banks, operate primarily via the internet. You can manage your accounts at an online bank from a computer or mobile device from anywhere at any time.

Overdraft. Something that occurs when you make a purchase with your debit card or write a check for an amount that exceeds your checking account's available balance. Many bank accounts offer overdraft protection to help avoid overdraft fees. Some banks don't charge overdraft fees at all.

Savings account. A savings account may have been your first experience with the banking industry. You have a number of options for where to stow your savings safely, both at banks and credit unions.

Solvency. When banks have enough money to cover potential losses. Banks are expected to maintain a sufficient level of capital to remain solvent and avoid failure. The FDIC and other federal regulators work with banks to maintain standards for solvency.

Wire transfers. Another type of electronic funds transfer (ETF), a wire transfer typically involves paying a fee, depending on whether the transfer is incoming or outgoing and domestic or international.