Chapter 6 — What Is Special About Banks

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1. Financial Intermediaries

Financial intermediaries are entities that facilitate the movement of money between lenders, borrowers, and other financial parties. They provide a safe and convenient environment for funds to flow through the financial system.

Banks are the most important financial intermediaries.

- **Definition:** A bank is a business that accepts deposits from customers and makes loans using those funds.

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2. Clearing and Settling Payments

Banks perform one of the **most crucial functions in the financial system: clearing and settling payments.**

- **Clearing:** Ensures that payment instructions (e.g., checks or electronic transfers) are correctly communicated to the receiving party.
- **Settling:** Involves transferring the actual money from the payer's account to the recipient's account. Once the settlement is complete, it is **final and irreversible.**

Example:

- You send $100 to a friend via your bank app. The clearing process verifies the instruction, and the settlement transfers the money into your friend's account.

2.1 Clearing House Model

Banks often use a **clearing house** to process payments between each other efficiently.

- **Netting:** Instead of transferring full amounts for each transaction, banks calculate the net amount owed between institutions and transfer only the difference, reducing transaction costs and risk.

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3. Payment Instructions

Payment instructions have evolved over history:

- **Goldsmith era:** Physical transfer of gold.
- **Paper era:** Checks as formal instructions to transfer money.
- **Modern era:** Electronic Funds Transfers (EFTs) – online transfers, credit card transactions, and mobile banking.

Key insight: Moving money costs time and resources, which is why banks charge fees for certain account types and services.

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4. Bank Deposits

Banks use deposited funds to make loans and earn interest. There are **two main types of deposits**:

1. **Demand Deposits**
   - Can be withdrawn at any time.
   - Example: Checking accounts for daily payments and EFTs.
   - Low interest because liquidity is high.
2. **Time Deposits**
   - Depositor agrees to leave funds for a minimum period.
   - Early withdrawal may trigger a **penalty** (significantly reduced interest).
   - Banks prefer these deposits because they provide stable funding to meet loan obligations.
   - Higher interest rates offered to incentivize depositors to commit for a longer term.

Explanation of penalty: If the depositor withdraws early, the bank loses the ability to lend these funds for the agreed time. The reduced interest is a cost-sharing mechanism to protect the bank.

5. Bank Lending

Banks provide loans to both businesses and individuals:

1. **C&I Lending (Commercial & Industrial)**
   - Loans to companies for business operations or expansion.
   - Also called **wholesale lending.**
2. **Retail Lending**
   - Loans to individual consumers, such as mortgages, personal loans, and auto loans.
3. **Lines of Credit**
   - A pre-approved borrowing limit that the borrower can draw upon as needed.
   - Interest is charged only on the portion used, not the full limit.
   - Example: A credit line of $10,000: if you withdraw $4,000, interest is charged on $4,000, not $10,000.

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6. Net Interest Margin (NIM)

Banks earn profits mainly from the difference between interest earned on loans and interest paid on deposits. This is measured by **Net Interest Margin (NIM):**

1. **Average interest earned on loans:**

$$Interest\ Earned\ Ratio\ = \frac{Total\ Interest\ Earned}{Total\ Interest -\ Earning\ Assets}$$

2. **Average interest paid on deposits:**

$$Interest\ Paid\ Ratio = \frac{Total\ Interest\ Paid}{Total\ Deposits}$$

3. **Net Interest Margin:**

$$NIM\ =\ Interest\ Earned\ Ratio\ -\ Interest\ Paid\ Ratio$$

- Typical range: **2–8%**
- NIM reflects how efficiently banks earn from lending versus their cost of funds.

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7. Why Banks Are Dominant Lenders

Banks have a **unique information advantage**:

1. **Customer Data:**
   - When you open an account, banks collect information about your income, spending, assets, and repayment history.
2. **Long-term tracking:**
   - Most people stay with the same bank for years, allowing banks to monitor financial behavior over time.
3. **Creditworthiness assessment:**
   - Banks use this accumulated information to identify which customers are reliable borrowers.

Key insight: Only people with accounts can usually get loans, because the bank has detailed information to monitor creditworthiness. This gives banks a **tremendous advantage** over other lenders.