Banking Basics

Federal Reserve Bank of Boston

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Some young savers stash their cash in old coffee cans, shoe boxes, or jelly jars. Others use "piggy banks," which today more likely resemble spacecraft or cartoon characters.

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

Perhaps you have had to face such a decision yourself. If you decide to keep your money at home, it will not earn any interest. You also run the risk that a burglar, a fire, or some other disaster will wipe out your life savings in the wink of an eye.

Then again, if you open a bank account, you cannot "visit" your money as easily as you can when it sits in your dresser drawer. You cannot just walk into a bank in the middle of the night to count your cash. You cannot 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 are counting on someone else to handle your money responsibly. Before you do that, it might be a good idea to understand how a bank operates.

This pamphlet will not tell you everything about banks and banking, but it will answer many of the most common questions.

What is a bank?

A bank is a business. But unlike some businesses, banks do not manufacture products or extract natural resources from the earth. Banks sell services 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 go to the bank seeking money for loans to buy houses and cars, start businesses, expand farms, 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 mediators between people who save and people who want to borrow. If savers do not put their money in banks, the banks have little or no money to lend.

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

How do people start banks?

The process of starting a bank varies from state to state, but here's a simple version of what it takes to start a bank in Massachusetts:

1. At least fifteen individuals get together and decide to start a bank.

2. They file an application with the Commonwealth's Board of Bank Incorporation (BBI), which consists of the Commissioner of Banks, the Commissioner of Revenue, and the Treasurer.

3. If the application is deemed complete, a hearing before the BBI is held.

4. The BBI, by law, must look closely at the financial condition and the character of the applicants as well as the capital structure for the proposed bank. In addition, the BBI will consider whether the public convenience and advantage will be promoted by the establishment of the new bank. The BBI will also look at the adequacy of the banks in the area to be served.

5. The BBI will then either grant a Certificate of Public Convenience and Advantage or deny the application.

6. The group that applied to start the bank will then have one year to raise necessary capital, secure a full management team, and obtain federal deposit insurance. The BBI currently requires at least $8 million in capital to start a bank.

7. The group will give notice to the BBI upon successfully raising the minimum capital. The BBI will review the list of proposed investors. If the BBI has no objection to such a list, if the bank is insured, and if an acceptable management team is in place, it will issue a Certificate to Transact Business and the bank may open for business.

How did banking begin?

No one knows who started the world's first bank, but it's safe to say that banking has its roots in the early trading civilizations of the Mediterranean. Without trade there would have been little need to establish banks, and without banks there would have been far less money to finance trading ventures.

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. You don't grow the olives and spices yourself; you buy them from growers or other merchants. If all goes well, you will be paid for your cargo when you reach your destination, but before you set sail you must have money to outfit your ship.

You find it by seeking out people who have money sitting idle. They agree to put up the money for your cargo and supplies in exchange for a share of you profits when you return from you voyage … if you return.

The people with the idle 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 your 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, most people who want to borrow money go to banks rather than to wealthy individuals. But the basic concepts of borrowing and lending have not really changed. People do not let you have their money for nothing.

It is risky to lend money. The lender has no guarantee that he or she will get the money back, even if the borrower is an old friend. So why lend money? Why take the risk? Because lending presents an opportunity to make even more money. People will often take a financial risk if they believe there is a good chance of making more money.

For example, if a bank lends $50,000 to a borrower, the bank 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 payoff.)

Of course, the opportunity to earn lots of interest will not mean much if a borrower fails to repay a loan. Because of this risk, banks often refuse to make loans that seem too risky. In deciding whether or not to give an individual a loan, they generally consider his or her credit rating or ability to pay their bills. They consider:

- how much and what types of credit you use, such as credit cards, auto loans, or other consumer loans;
- how long you have had and used credit; and
- how promptly you pay your bills.

Banks also use interest to attract savers. After all, people who have extra money do not have to put it in the bank. They have lots of choices:

a. They can bury it in the backyard or stuff it in a mattress. But if they do that, the money will just sit there. It will not increase in value. It will not earn interest.

b. They can buy land or invest in real estate. But real estate can tie up an investor's money because buildings and land can take a long time to sell if the market is weak. And there is always the risk the real estate will drop in value.

c. They can invest in the stock market. But if the stock market drops, investors can lose their money.

d. They 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 is time to sell? (In 1980, gold sold for $800 an ounce. By 1983, the price had sunk below $400.)

Or they can put their money in a bank. Not only will the money be safe, but it may also earn interest, depending on the type of account selected. Additionally, many types of bank accounts offer depositors the added advantage of being able to get at their money quickly.

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. They now offer many of the same services, but once 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 individual customers, 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 bluecollar workers, clerks, and domestic workers a secure place to save for a "rainy day." T hey 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 these 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.

How do I choose a bank?

In the 1950s and 1960s, banks used to give away toasters to new depositors. Choosing a bank was easy. You went to the one that gave away the best toaster.

Banks generally do not give away toasters anymore, and choosing a bank is a little more complicated than it used to be. For starters you should shop around to find out which banks offer the most competitive services. 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 a fee for every transaction you make, especially withdrawals of any sort. You do not 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 its 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 services?

Before you open an account, ask a few people if they are happy with their bank. All banks are not the same. You have to do some comparison shopping before you open an account.

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 keep their household finances in order; others need to meet a business payroll. 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 do not need a lot of money to open a savings account, and you can withdraw your money at any time.

Checking accounts offer safety and convenience. You keep your money in a checking 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. (It is likely gone forever.)

Another attractive feature of a checking account is that every month your bank sends you all the checks you have written, and you can use them as receipts if a disagreement arises over whether or not you paid a bill. Businesses use checking accounts to hold the money they receive and to transfer money to other people or other businesses. Checking accounts do not earn interest. These are the types of accounts on which banks generally charge fees because banks incur significant costs to process the checks drawn on checking accounts.

NOW accounts are checking accounts that pay interest. (NOW stands for Negotiable Order of Withdrawal.) Sometimes banks require you to keep a certain minimum amount of money (a minimum balance) in your NOW account in order to keep earning interest. Only non-business customers may open NOW accounts; businesses must use regular checking accounts that do not pay interest.

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

Certificates of deposit (CDs) are savings deposits that require customers to keep a certain amount of money in a bank for a fixed period of time (example: $1,000 for two years). As a rule, the rate of interest your money earns is higher if you agree to keep your money on deposit for a longer period of time, so the bank can plan on using your money for a longer period of time. Banks do not offer check-writing privileges on certificates of deposit.

Individual retirement accounts are savings deposits that require customers to keep their money in the bank until they reach a certain age. Generally, these accounts offer excellent rewards to customers who make these long term deposits. However, one must be careful because banks can charge a significant penalty to individuals who withdraw their funds from these accounts before they reach a specified age (usually age 60 or older).

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

Is it difficult to open an account?

You have 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 should be recorded in your bank book. It is especially important for you to keep track of your transactions in your bank book.

You do not need lots of money to start a savings account. Some banks let you open one with as little as twenty dollars. Nor do you need to wait until you are eighteen. 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.

What happens to your money after you deposit it in your bank account?

What happens to a ten-dollar bill after you deposit it in your savings account? Does the bank teller take it to a vault and put it into a separate compartment or cubbyhole marked with your name and account number ? No.

The bank begins by adding ten dollars to the amount that is already in your account (your existing balance). Your ten dollar deposit and your new balance are then recorded in your bank book and in the bank's computer system. The ten dollar bill you deposited is mixed in with all the other cash your bank receives that day.

When you and other customers deposit money in a bank, the bank "puts most of it to work." Part of the money is set aside and held in reserve, but much of the rest is loaned to people who need to borrow money in order to buy houses and cars, start or expand businesses, buy farm equipment or plant crops, or do any of the other things that require people to borrow money.

Of course, banks do not lend money just to provide a service. They do it to make money. Here's how it works:

When you keep your savings in a bank, the bank pays you extra money, which is called interest. The interest is added to your account on a regular basis, usually once a month or once every three months.

Let's say a bank pays its depositors interest of three percent a year on their savings. In simple terms, that means if you keep $100 in your savings account, the bank will add three dollars to your account balance during the course of a year.

But, there is another side to interest. When someone borrows money from a bank, the bank charges interest, and it charges borrowers a higher rate than it pays savers. For example, it might pay savers three percent and charge borrowers eight percent. The difference, eight percent minus three percent, goes to the bank. Charging interest on loans is one of the main ways for a bank to make money.

The rate of interest a bank charges borrowers largely depends on two things:

1. how many people want to borrow money, and
2. how much money banks have available to lend.

If a bank has plenty of money to lend and the demand to borrow money is not particularly strong, interest rates will tend to be low in order to attract customers. But when banks have a smaller amount of money to lend and the demand to borrow is fairly strong, interest rates will rise. As a depositor, you want interest rates to be high, but as a borrower, you want them to be low.

When it comes to paying interest on savings deposits, one bank usually pays much the same rate as another. The rate that one bank pays needs to be competitive with the rate that other banks pay, and it needs to be just high enough to attract deposits. If a bank is offering a much better (higher) rate than most other banks, try to find out why. And remember the old adage: *If something sounds too good to be true, it probably is.*

What happens when someone applies for a loan?

Your old car has carried you faithfully over many miles of highway, but last week your mechanic advised you not to spend any more money on it. The time has come to shop around for a new one.

But cars were a lot cheaper when you last bought one. This time you will have to borrow most of the money from a bank.

Your first step is to decide on a bank. You do not necessarily have to take out a loan from the bank where you have an account. In fact, you should around for a bank that offers the best deal, including the best (lowest) interest rate.

In addition to seeking out local banks you can also use the Internet if you have access. There are a wealth of resources available her that you can research from the comfort of your home or office.

You will not know if you can afford the loan, or if the bank will be willing to lend you the amount you are seeking, until after you complete the bank's loan application. In addition to routine personal information such as your name, address, telephone number, and social security number, a loan application also asks for information on how much money you earn, how long you have worked at your current job, and how much money you already owe on credit card bills and other debts.

People in the bank's loan department then evaluate your application and try to decide if you are a "good risk." Before they lend you money, they want to be as certain as possible that you will be able to pay them back. Do you make enough money to keep up with your loan payments? Have you always paid your debts on time, or do you have a history of falling behind on your bills? To answer these questions, lenders rely heavily on credit bureaus and credit reports.

There are approximately 1200 local and regional credit bureaus in the United States. All are private companies (not government agencies), and most are linked by computer to three nationwide credit bureaus. They provide lenders with much of the information needed to evaluate loan applications.

When you apply for a loan, your bank contacts a credit bureau and asks for a copy of your credit report, which is basically a summary of your payment habits. Most credit reports contain information about loans, charge accounts, credit card accounts, bankruptcies, and court judgments that might require the potential borrower to pay a large sum of money as a settlement.

How the information gets into your credit report is no mystery. When you apply for a new charge account or credit card, clerks transfer information from your application to computer tapes that are forwarded to one or more of the nationwide credit bureaus. The information is updated every month. If you are late in paying your bills or if you miss a payment, the information goes into your credit report. Lenders then evaluate your report and try to decide if you are a "good risk."

After weighing all the information, your bank will either approve or deny your loan request. If your request is denied, the bank must notify you in writing within 30 days. The letter must state the reason for denying your loan. If your loan is approved, the bank will give you a check made out to your auto dealer. To protect itself in case you fail to repay the loan, your bank will hold the legal title (ownership papers) to your purchase until you pay off the loan.

Before you apply for a loan, you should request a copy of your credit report. If you have any questions beforehand, you may be able to address them before processing a loan application. Generally, you can do this rather quickly either over the Internet or by a telephone call for a very small fee.

What are checks, and how do they work?

You reach for your wallet and it is not there. Rifling through your pockets, you become more and more frantic. Finally, panic gives way to despair when you realize your wallet is gone and your cash, too. Chances are you will never see the cash again.

The consequences are not nearly as serious if you lose your checkbook. All you do in that case is close your checking account and open a new one. After that, your lost or stolen checks are worthless to anyone who might try to use them.

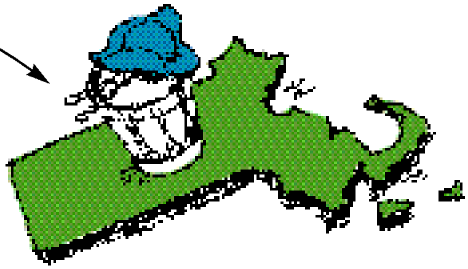
Because they are safe and convenient, checks have become a very popular method of paying for things or transferring money. But what exactly is a check?

In simple terms, a check is a written set of instructions to your bank. When you write a check, you are instructing your bank to transfer a specific amount of money from your checking account to another person or an organization. You can even write a check just to convert some of the money on deposit in your checking account into cash.

When you fill in the blank spaces on one of your checks, you are telling your bank how much of your money you want to transfer, when you want to transfer it, and to whom you want it to go. You authorize the transfer by signing the bottom of the check.

One reason why checks are so popular is that people can use a cancelled check to prove they have paid a bill. In most cases, a cancelled check is as good as a receipt because it bears the endorsements of all the persons, banks, companies, or other organizations that have handled it. For example, if the landlord claims you did not pay your rent, all you need to do is find your cancelled check and point out that it was endorsed by your landlord and your landlord's bank.

Tracing a check through the Federal Reserve's Check Collection Network

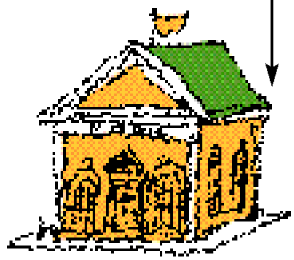


1

Your Aunt Bea in Atlanta sends you a $20 check for your birthday. (Money! The gift that's always in good taste!)

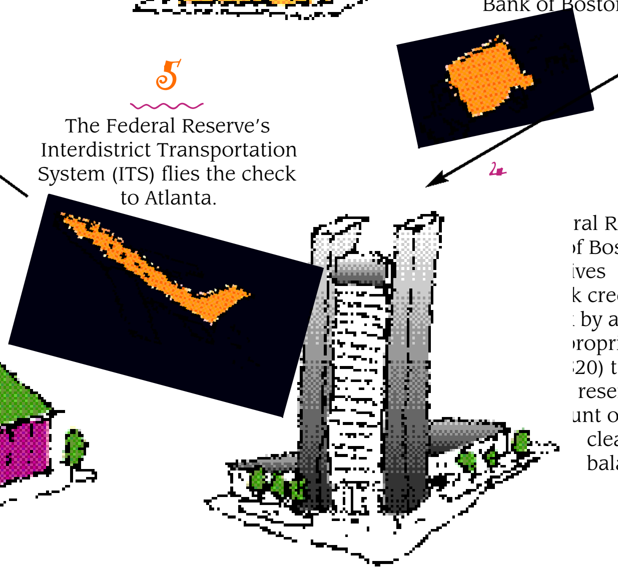
2

You deposit the check in your bank account.



3

Your Bank encodes and endorses the check. Then it sends the check to the Federal Reserve Bank of Boston.



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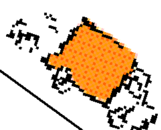
The Federal Reserve's Interdistrict Transportation System (ITS) flies the check to Atlanta.

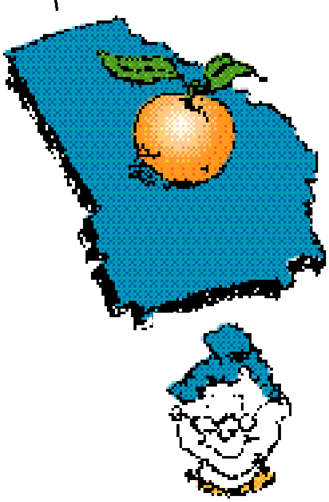


6

When the Federal Reserve Bank of Atlanta receives the shipment of checks from Boston, it forwards the checks to Aunt Bea's bank and deducts the appropriate amount from that bank's reserve account.

7

Her Bank deducts $20 from Aunt Bea's checking account. At the end of the month her Bank will send Aunt Bea a monthly statement and her cancelled checks.



If for some reason Aunt Bea did not have enough money in her account to cover the $20 check, then the check would "bounce." It would be sent back to Your Bank marked "NSF" – not sufficient funds. (Of course, Aunt Bea would never do that to you.)

What do people mean when they talk about "electronic banking"?

The bank closes in ten minutes. Even if you make it there in time to cash your check, your nerves will be frazzled. Isn't there an easier way?

And, they are right. Electronics and computers have turned banking into a round the clock business. You can now do much of your banking even when the doors to your bank are locked. You no longer need to plan your schedule around your bank's business hours.

Is it difficult for you to get to the bank when the bank is normally open? Automated teller machines (ATMs) now make it possible for you to do much of your banking whenever you choose.

Automated teller machines are computers that are much like limited-service bank branches. You can use them to make a withdrawal, make a deposit, make a loan payment, transfer money from one account to another, or check your account balance. In some cases, automated teller machines of different banks are linked together so you can use them when you travel to a different part of town or even to another state. All you need to use an ATM is a plastic card from your bank and your own password.

Tired of rushing to the bank to cash your paycheck? Ask your employer about direct deposit, a banking service that makes it possible for you to have your money electronically added to your checking account every payday. Instead of receiving a paycheck, you receive a statement that tells you your money has already been deposited in your account. Direct deposit is popular among people who receive Social Security checks or pension checks because it saves them the bother of standing in line at the bank, battling bad weather, or worrying about being robbed on the way home from the bank.

Another electronic banking service is called electronic funds/transfer, or EFT. By using EFT, a bank can transfer large amounts of money to another bank by sending an electronic message. An individual does not need to write a check. A bank will not have to load up an armored car with cash. Moreover, the money can be moved without a long wait.

Electronic transfers take only an instant. An electronic message instructs a computer to deduct a certain amount of money from one bank account and then add the same amount to another bank account. The message is sent, and the appropriate amount is transferred. No cash or paper changes hands, but money is transferred just the same.

Recent developments in technology have also afforded people the opportunity to bank from the comfort and security of their homes. Several banks have developed software packages that allow customers to debit or credit their accounts, check account balances, or even apply for a loan. Consumers can make these transactions using either a touch-tone phone or a computer with a modem that gives them access to the Internet.

Today, there are "virtual banks" that have no physical bank office in a traditional way. They provide all of their services to their customers via the Internet. While only an estimated one to two percent of households use Internet banking right now, this method of banking should grow in popularity as more people can access the Internet.

One final note on electronic banking: People have been predicting for years that electronic banking will someday replace checks and cash, but so far the predictions have not been accurate. Electronic banking has grown steadily, but the use of checks and the amount of cash in circulation has grown simultaneously. People like to use cash and checks because they are familiar and convenient methods of payment.

Do banks keep large amounts of gold and silver in their vaults?

Banks rarely keep gold or silver in their vaults anymore. That is because our paper money is no longer backed by gold or silver, and our coins do not contain precious metal.

The U.S. government still holds millions of ounces of gold and silver, but citizens and foreign governments can no longer exchange their U.S. paper money for the precious metals. The government's gold and silver are considered valuable assets and precious metals rather than forms of money. Today's coins and paper money (currency) are backed by the "full faith and credit" of the United States government – the promise of the U.S. government.

If that makes you a little uneasy, try and the following exercise. Put a ten-dollar bill and a blank piece of paper on a tabletop, then ask people to choose between the two. Chances are everyone will choose the ten-dollar bill.

Why? After all, neither the ten-dollar bill nor the blank piece of paper is backed by gold or silver.

The difference is that people all over the United States will accept the ten-dollar bill as payment if you want to buy something, but you would have a hard time finding someone willing to accept the blank piece of paper in exchange for goods or services.

People accept the ten-dollar bill because it is backed by the promise of the United States government. To most people, that promise is as good as gold.

Of course, coins and currency are not the only forms of money. You do not have to keep your money in the form of cash. Money held in a savings account or a checking account is still money it just is not cash.

Contrary to popular belief, credit cards are not a form of money even though people often refer to them as "plastic money." Credit card users are actually taking out a loan, and sooner or later they will have to pay the bill for all those things they have charged. They are buying something now and agreeing to pay for it at a later date with money, usually a check.

Many banks issue credit cards, even to people who aren't regular customers. Before issuing you a credit card, a bank will require you to complete an application form and will examine your credit record to see if you have a history of paying back your debts on time. (See page 16 for more information on credit records.)

Many people run up credit card bills that are too big to pay off every month. When that happens, customers must pay a monthly finance charge that can run as high as 20 percent a year. In addition, many banks and other companies that issue credit cards charge their cardholders an annual fee. Even customers who pay off their entire credit card bill every month still have to pay the annual fee. Banks and credit card companies also charge merchants a fee for making the credit card service available. Finance charges, annual fees, and merchant fees have become an important source of income for banks.

Finally, there's another plastic card that resembles a credit card in appearance but is actually very different in function – the debit card. A debit card is more like an ATM card than a credit card. When someone uses a debit card at the gas pump or at a store, the amount of the purchase is electronically deducted from the user's bank balance. There is no monthly bill because the amount of each purchase is deducted almost immediately from the user's account. With this card, many merchants will offer you the opportunity to get cash back, too, when you pay for your purchase using your debit card.

Why do banks fail, and what happens when they do?

A bank is a business, and like other businesses, banks sometimes fail. But why should banks go out of business? Don't they have lots of money?

Sometimes banks fail because the people who run them make poor business decisions such as expanding too quickly or putting too much money into one type of loan.

Sometimes banks fall because of fraud. Maybe the president makes questionable loans to friends or hires unqualified relatives and pays them huge salaries.

Things like that happen, and they sometimes lead to bank failures. But in most cases, banks go out of business because changing economic conditions make it difficult or impossible for borrowers to repay their loans. For example:

Gusher National Bank Slips on Falling Oil Prices.

Falling energy prices mean cheaper gasoline and lower home heating bills. Falling oil prices must be good, right?

Not for everyone! Take the case of Gusher National Bank. Gusher was very aggressive in making loans to oil and natural gas companies, and as long as energy prices were high, the borrowers had no problem repaying their loans. The loans spelled big profits for Gusher, and everyone agreed that Gusher's executives were smart business people who really knew how to make money.

Then the economy slowed down, and the demand for energy fell. Factories burned less oil and natural gas. Truck drivers, commuters, and vacationers drove fewer miles and burned less gasoline and diesel. As a result, energy prices dropped sharply, and many energy companies began to fall behind on their loan payments. Some even stopped making payments altogether.

Months passed, and oil prices failed to increase. More borrowers fell behind on their payments. Finally, Gusher lost so much money to bad loans that government regulators stepped in and closed the bank. Gusher had fallen victim to changing economic conditions, falling energy prices, and a high concentration of loans to energy companies.

Or take the case of Bedrock Bank...

Bedrock Bank Gets Too Big Too Fast.

Bedrock's new president was determined to turn the conservative old institution into the region's biggest bank. Bedrock's loan officers got the message and started making as many loans as they could for condominium developments, shopping centers, office buildings, and high priced suburban housing developments. Loan applications were not always checked as closely as they had been in the past, and some of the loans were approved more quickly than they were in the old days. But nobody seemed too concerned because the local economy was strong and real estate values were rising rapidly.

Everything seemed fine; everyone was making money. But then the economy slowed down, and things took a turn for the worse. The weak economy forced many businesses to close, leaving lots of vacant office space. Real estate values in Bedrock's area plummeted, and many developers started to fall behind on their loan payments.

In the end, Bedrock Bank was losing so much money on bad real estate loans that government regulators were forced to step in and close it. The regulators tried to find a buyer for Bedrock, but no other bank wanted to get stuck with all the loans that had turned sour. Eventually, another bank agreed to buy Bedrock if the federal government would agree to keep many of the problem loans.

Do depositors lose their money when a bank fails?

The Federal Deposit Insurance Corporation (FDIC) has protected bank deposits since 1934. In all that time, no one has lost money in an FDIC-insured account.

Federal deposit insurance covers most types of deposits, including savings deposits, checking deposits, and certificates of deposit. The basic insured amount is $100,000 per depositor.

In the days before federal deposit insurance, the U.S. banking system was plagued by bank "runs" or "panics." At the slightest hint of trouble, depositors would run to the bank and line up to withdraw their money. All too often, only the first few people in line had any hope of ever seeing their money again; others lost everything. Even healthy banks sometimes failed after rumors caused depositors to panic and withdraw their money.

For many years, the public seemed willing to accept the tragic losses that resulted from bank failures. But then came the Great Depression of the 1930s. Hard times and financial pressures forced thousands of banks to close their doors forever. Financial losses ran into the hundreds of millions of dollars. The human suffering was impossible to calculate.

The wave of bank failures had shattered public confidence in the banking system, and Americans looked to the federal government for help. Congress responded by establishing the FDIC, which provided deposit insurance coverage of up to $2,500 per depositor. Public confidence rebounded, and bank failures declined from approximately 4,000 in 1933 to 62 in 1934.

Over the years, federal deposit insurance has helped to maintain public confidence in the U.S. banking system. Bank failures have not been eliminated, but long lines of panic stricken depositors have become an uncommon sight. When people are confident that their money is safe, they do not panic and rush to withdraw it.

Do depositors lose money if their bank is robbed?

No. Nearly all banks have private insurance that covers them if they are robbed. (It is not the same as federal deposit insurance.)

In addition, most banks take elaborate measures to safeguard the cash and other valuable items left in their care. Bank vaults have long been protected by reinforced concrete walls, time locks, and metal alloy doors that resist drilling and explosions.

At one time, armed security guards stood watch over banks, but today most banks seem to have decided (wisely) that they would rather not expose their customers and employees to gunplay. Shotguns and revolvers have been replaced largely by closed circuit television cameras that maintain a constant watch over everyone who enters or exits the bank.

Another fairly recent innovation is the exploding dye pack. In certain cases, bank employees are able to place a package of red dye in with the robber’s stash of stolen cash. Later, when the crook opens the stash, the concealed dye pack explodes, covering the robber and the illgotten money with dye that will not wash off.

What is the Federal Reserve and how does it fit into the U.S. banking system?

Although the Federal Reserve is often in the news, not everyone understands what it is and what it does. Perhaps the best way to clear things up is to have a Federal Reserve "Q & A" to cover some of the most common questions that people ask.

Q: What is the Federal Reserve?

A: It is the central banking system of the United States.

Q: What does it do?

A: The Federal Reserve has four main duties:

I. Conducting the nation's monetary policy by influencing money and credit conditions in the economy in pursuit of full employment and stable prices.

2. Supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers.

3. Maintaining the stability of the financial system and containing systemic risk that may arise in financial markets.

4. Providing certain financial services to the U.S. government, to the public, to financial institutions, and to foreign official institutions, including playing a major role in operating the nation's payments system.

Q: When was the Federal Reserve established?

A: Congress created the Federal Reserve System in 1913 to help make the U.S. banking system safer and more efficient.

Q: How many Federal Reserve Banks are there?

A: There are 12 Federal Reserve Banks, 25 branches to those banks, and several regional check processing centers that are limited service branches that only process checks. Each of the 12 Reserve Banks serves its own Federal Reserve District.

Q: Where is the headquarters for the Federal Reserve?

A: The System's headquarters is in Washington, D.C. It is called the Board of Governors of the Federal Reserve System.

Q: Does the Federal Reserve lend money to people who want to start businesses or buy cars and houses?

A: No. The Federal Reserve does not lend money to private borrowers, but it sometimes lends money to banks when the need arises.

Q: Does the Federal Reserve print U.S. paper money?

A: No. Although Federal Reserve Notes account for almost 100 percent of the U.S. paper money in circulation, the notes are actually printed by the Bureau of Engraving and Printing in Washington, D.C. and Fort Worth, Texas. The paper money is then shipped to the Federal Reserve Banks and their 25 branches. When banks need cash for their customers' needs, they order it from the Federal Reserve Bank in their District. Also, as money becomes worn, the Federal Reserve Banks process cash in order to determine its fitness. Once bills are shredded, new bills are introduced into the system to replace the old ones. These new bills are partially identifiable by the bank from which their distribution originated.

Q: Do all Federal Reserve Banks store gold bars in their vaults?

A: Only the Federal Reserve Bank of New York has a working gold vault, and almost all of the gold in its vault is foreign owned. The U.S. government's gold is held at Fort Knox, Kentucky, the U.S. Mints in Denver and Philadelphia, the San Francisco Assay Office of the U.S. Mint, and the U.S. Bullion Depository in West Point, New York.

Q: Do all checks written in the U.S. go through the Federal Reserve System?

A: No. The Federal Reserve Banks handle less than one third of all U.S. checks. Private entities process the rest.

Q: Is the Federal Reserve responsible for regulating and supervising the entire U.S. banking system?

A: No. It shares the responsibility with other regulatory agencies including the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the National Credit Union Administration, and the banking commissions in each state.

Q: Does the Federal Reserve set interest rates?

A: The Federal Reserve is responsible for U.S. monetary policy. This means it makes policies that influence how much money and credit will be available to the U.S. economy. Interest rates often go up or down in response to the Federal Reserve's monetary policy decisions, but only the discount rate is set directly by the Federal Reserve. The discount rate is the rate paid by banks when they borrow from the Federal Reserve.

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