Lecture 4: The Business of Banking

Introduction

So, we've discussed the history of usury, interest, and the development of banks. We've covered central banking, but now let’s focus on the financial institution we all interact with regularly—**the bank**. What does a bank actually do? How does it function? How does it make money, and what role does it play in the economy?

What Do Banks Do?

A bank primarily **lends money** to businesses, consumers, and various projects, both for productive use and for consumption. Banks are essential to what's called **consumption smoothing**, which is the idea that you can borrow money now (e.g., for a house or a car) and pay it back over time, smoothing your consumption over the course of your lifetime. This allows you to enjoy goods now, like buying a house, even if you don’t have the full amount upfront. For example, most people use **mortgages** to purchase homes, and this borrowing allows you to live in the house long before it's fully paid off.

Banks also fund **businesses**, **real estate projects**, and **infrastructure**, enabling the economy to function and grow. However, banks do not lend money to everyone. **Selectivity** is a critical function of banking. Banks decide who gets a loan and who doesn't, ensuring that money is directed toward **productive, profitable projects** rather than **irresponsible or unwise ventures**.

How Banks Make Money

Banks attract **deposits** and then lend out most of the money they hold. They make money by charging a higher **interest rate** on the loans they give compared to the interest they pay on the deposits. Banks hold two types of deposits:

1. **Demand Deposits**: These are checking accounts, where you can withdraw your money at any time.
2. **Time Deposits**: These are savings accounts, certificates of deposit (CDs), or money markets, where money is deposited for a specific period.

Banks have to **manage risk** and **liquidity** carefully. They don't keep all the deposited money in cash; instead, they lend it out or invest it in **securities**. This is known as **fractional reserve banking**—the system where banks keep only a fraction of their deposits in reserve and lend out the rest.

The Mechanics of Fractional Reserve Banking

In the traditional fractional reserve banking system, banks only have to keep a portion of their deposits in reserve. For example, if a bank receives $100, it may only keep $10 in reserve and lend out the other $90. This process creates more money in the economy, as that $90 lent out gets deposited in another bank, which can then lend out 90% of that amount. This multiplier effect leads to the creation of more money in the system.

Risks of Fractional Reserve Banking

If too many people request their deposits at once (a **bank run**), the bank may not have enough liquid assets to pay them all, which can lead to bankruptcy. Even though fractional reserve banking increases economic activity, it also makes the system fragile.

Moral Hazard in Banking

Moral hazard occurs when banks take excessive risks because they know the **government will bail them out** if things go wrong. This happens because of **deposit insurance** (FDIC), which protects depositors. When banks know that **uninsured deposits** will be covered by the government, they may take on higher risks than they would otherwise.

Example of Moral Hazard

Silicon Valley Bank (SVB) serves as a modern example of this issue. It had many deposits from venture capital firms and startups. During the COVID-19 pandemic, SVB began investing heavily in long-term government securities. However, as

interest rates rose and the value of these bonds fell, SVB found itself unable to meet its depositors' demands for withdrawals. This triggered a **bank run**, and despite the bank's solvency on paper, it failed because of liquidity issues.

The **FDIC** and **government regulators** intervened and **bailed out** the depositors, even those with more than $250,000 in deposits, creating a moral hazard because it incentivized banks to take greater risks knowing the government would step in to cover potential losses.

The S&L Crisis

The **S&L Crisis** of the 1980s is another case study in moral hazard. Savings and loan associations (S&Ls) were allowed to invest in a wider variety of loans. They had previously only been allowed to issue mortgages at low, fixed rates. But as inflation increased, S&Ls faced a situation where they had to offer higher interest rates to attract deposits, even though their existing mortgages were still low-yielding. This mismatch led them to take on speculative, high-risk loans that ultimately resulted in their collapse. The government stepped in to bail out these institutions, costing taxpayers billions of dollars.

Silicon Valley Bank (SVB) Example

SVB's downfall provides a clearer picture of how modern banks can fail due to a mismatch in **liabilities** and **assets**. The bank had deposited funds from tech startups and venture capitalists but invested those funds in **long-term securities**. When inflation rose and interest rates increased, the value of these long-term bonds dropped. When **withdrawal requests** surged due to concerns over the bank's solvency, SVB couldn't meet those demands. The government had to step in, bailing out depositors, creating more **moral hazard** in the system.

Government's Role and Bank Regulation

The government has created an intricate regulatory environment, with multiple agencies such as the **FDIC**, **OCC**, and **the Federal Reserve**, tasked with ensuring the stability of the banking system. However, the continued presence of **moral hazard** means that these regulations often fail to stop risky behavior. While some regulations, like **Dodd-Frank**, were created to prevent another financial crisis, they haven't solved the underlying problems of risk-taking in banks.

Conclusion

Banks are central to the economy, but the system is fragile. The **fractional reserve system** creates money, but it also creates risks, particularly during times of economic stress. The presence of **moral hazard**, where banks take excessive risks knowing they will be bailed out, contributes to the instability of the system. While regulatory measures have been implemented, the underlying issues persist, and the financial system remains vulnerable to crises.

Next class, we will dive into the **stock market**, followed by a discussion on **financial crises**, the **fragility of the system**, and **the future of finance**.

Key Points:

- Banks lend money to businesses, consumers, and projects, facilitating **consumption smoothing** and **economic growth**.
- **Fractional reserve banking** allows banks to lend out most of the money they receive, creating more money in the system.
- Banks face risks, particularly from mismatched **liabilities** and **assets**, which can lead to **bank runs** and failures.
- **Moral hazard** arises from deposit insurance and government bailouts, encouraging risky behavior in banks.
- **Regulation** has been increased, but it does not fully address the root causes of banking crises.