

History of Banking

A **banker** or **bank** is a **financial institution** whose primary activity is to act as a payment agent for customers and to borrow and lend money. It is an institution for receiving, keeping, and lending money. The first modern bank was founded in Italy in Genoa in 1406 and its name was Banco di San Giorgio (Bank of St. George).

Many other financial activities were added over time. For example banks are important players in financial markets and offer financial services such as investment funds. In some countries such as Germany, banks are the primary owners of industrial corporations while in other countries such as the United States banks are prohibited from owning non-financial companies. In Japan, banks are usually the nexus of cross share holding entity known as Zaibatsu. In France "Bancassurance" is highly present, as most banks offer insurance services (and now real estate services) to their clients.

Contents

- 1 History
 - 1.1 Origin of the word
- 2 Traditional banking activities
- 3 Definition
- 4 Accounting for bank accounts
- 5 Wider commercial role
- 6 Economic functions
- 7 Law of banking
- 8 Entry regulation
- 9 Banking channels
- 10 Types of banks
 - 10.1 Types of retail banks
 - 10.2 Types of investment banks
 - 10.3 Both combined
 - 10.4 Other types of banks
 - 10.4.1 Islamic banking
- 11 Banks in the economy
 - 11.1 Size of global banking industry
 - 11.2 Bank crisis
- 12 Challenges within the banking industry
- 13 Profitability

History

Main article: History of banking

Banks have influenced economies and politics for centuries. Historically, the primary purpose of a bank was to provide loans to trading companies. Banks provided funds to allow businesses to purchase inventory, and collected those funds back with interest when the goods were sold. For centuries, the banking industry only dealt with businesses, not consumers. Banking services have expanded to include services directed at individuals, and risks in these much smaller transactions are pooled.

Origin of the word

The name *bank* derives from the Italian word *banco* "desk/bench", used during the Renaissance by Florentine bankers, who used to make their transactions above a desk covered by a green tablecloth. However, there are traces of banking activity even in ancient times.

In fact, the word traces its origins back to the Ancient Roman Empire, where moneylenders would set up their stalls in the middle of enclosed courtyards called *macella* on a long bench called a *bancu*, from which the words *banco* and *bank* are derived. As a moneychanger, the merchant at the *bancu* did not so much invest money as merely convert the foreign currency into the only legal tender in Rome—that of the Imperial Mint.

Traditional banking activities

Banks act as payment agents by conducting checking or current accounts for customers, paying cheques drawn by customers on the bank, and collecting cheques deposited to customers' current accounts. Banks also enable customer payments via other payment methods such as telegraphic transfer, EFTPOS, and ATM.

Banks borrow money by accepting funds deposited on current account, accepting term deposits and by issuing debt securities such as banknotes and bonds. Banks lend money by making advances to customers on current account, by making installment loans, and by investing in marketable debt securities and other forms of money lending.

Banks provide almost all payment services, and a bank account is considered indispensable by most businesses, individuals and governments. Non-banks that provide payment services such as remittance companies are not normally considered an adequate substitute for having a bank account.

Banks borrow most funds from households and non-financial businesses, and lend most funds to households and non-financial businesses, but non-bank lenders provide a significant and in many cases adequate substitute for bank loans, and money market

funds, cash management trusts and other non-bank financial institutions in many cases provide an adequate substitute to banks for lending savings to.

Definition



Cathay Bank in Boston's Chinatown

The definition of a bank varies from country to country.

Under English common law, a banker is defined as a person who carries on the business of banking, which is specified as:

- Conducting current accounts for his customers
- Paying cheques drawn on him, and
- Collecting cheques for his customers.

In most English common law jurisdictions there is a Bills of Exchange Act that codifies the law in relation to negotiable instruments, including cheques, and this Act contains a statutory definition of the term *banker*: *banker* includes a body of persons, whether incorporated or not, who carry on the business of banking' (Section 2, Interpretation). Although this definition seems circular, it is actually functional, because it ensures that the legal basis for bank transactions such as cheques do not depend on how the bank is organized or regulated.

The business of banking is in many English common law countries not defined by statute but by common law, the definition above. In other English common law jurisdictions there are statutory definitions of the *business of banking* or *banking business*. When looking at these definitions it is important to keep in mind that they are defining the business of banking for the purposes of the legislation, and not necessarily in general. In particular, most of the definitions are from legislation that has the purposes of entry regulating and supervising banks rather than regulating the actual business of banking. However, in many cases the statutory definition closely mirrors the common law one. Examples of statutory definitions:

- "banking business" means the business of receiving money on current or deposit account, paying and collecting cheques drawn by or paid in by customers, the making of advances to customers, and includes such other business as the Authority may prescribe for the purposes of this Act; (Banking Act (Singapore), Section 2, Interpretation).
- "banking business" means the business of either or both of the following:
 1. receiving from the general public money on current, deposit, savings or other similar account repayable on demand or within less than [3 months] ... or with a period of call or notice of less than that period;
 2. paying or collecting cheques drawn by or paid in by customers

Since the advent of EFTPOS (Electronic Funds Transfer at Point Of Sale), direct credit, direct debit and internet banking, the cheque has lost its primacy in most banking systems as a payment instrument. This has lead legal theorists to suggest that the cheque based definition should be broadened to include financial institutions that conduct current accounts for customers and enable customers to pay and be paid by third parties, even if they do not pay and collect cheques.^[6]

Accounting for bank accounts



Suburban branch bank

Bank statements are accounting records produced by banks under the various accounting standards of the world. Under GAAP and IFRES there are two kinds of accounts: debit and credit. Credit accounts are Revenue, Equity and Liabilities. Debit Accounts are Assets and Expenses. This means you credit accounts to increase their balances and you debit accounts to increase their balances.

This also means you debit your savings account every time you deposit money into it (and the account is normally in deficit) and you credit your credit card account every time you spend money from it (and the account is normally in credit).

However, if you read your bank statement, it will say the opposite- that you have credited your account when you deposit money and you debit when you withdraw it. If you have cash in your account you have a positive or credit balance and if you are overdrawn it will say you have a negative or a deficit balance.

The reason for this is because the bank, and not you, has produced the bank statement. Your savings might be *your* assets, but it is the *bank's* liability, so your savings account is a liability account which is a credit account and should have a positive credit balance. Your loans are your liabilities but the bank's assets so they are debit accounts which should have a negative balance.

Below where bank transactions, balances, credits and debits are discussed, they are done so from the viewpoint of the account holder which is traditionally what most people are used to seeing.

Wider commercial role

However the commercial role of banks is wider than banking, and includes:

- Issue of banknotes (promissory notes issued by a banker and payable to bearer on demand)
- Processing of payments by way of telegraphic transfer, EFTPOS, internet banking or other means
- Issuing bank drafts and bank cheques
- Accepting money on term deposit
- Lending money by way of overdraft, installment loan or otherwise
- providing documentary and standby letters of credit (trade finance), guarantees, performance bonds, securities underwriting commitments and other forms of off balance sheet exposures
- Safekeeping of documents and other items in safe deposit boxes
- Currency exchange
- Sale, distribution or brokerage, with or without advice, of insurance, unit trusts and similar financial products as a 'financial supermarket'

Economic functions

The economic functions of banks include:

1. Issue of money, in the form of banknotes and current accounts subject to cheque or payment at the customer's order. These claims on banks can act as money because they are negotiable and/or repayable on demand, and hence valued at par and effectively transferable by mere delivery in the case of banknotes, or by drawing a cheque, delivering it to the payee to bank or cash.
2. Netting and settlement of payments -- banks act both as collection agent and paying agents for customers, and participate in inter-bank clearing and settlement systems to collect, present, be presented with, and pay payment instruments. This enables banks to economize on reserves held for settlement of payments, since inward and outward payments offset each other. It also enables payment flows between geographical areas to offset, reducing the cost of settling payments between geographical areas.

3. Credit intermediation -- banks borrow and lend back-to-back on their own account as middle men
4. Credit quality improvement -- banks lend money to ordinary commercial and personal borrowers (ordinary credit quality), but are high quality borrowers. The improvement comes from diversification of the bank's assets and the bank's own capital which provides a buffer to absorb losses without defaulting on its own obligations. However, since banknotes and deposits are generally unsecured, if the bank gets into difficulty and pledges assets as security to try to get the funding it needs to continue to operate, this puts the note holders and depositors in an economically subordinated position.
5. Maturity transformation -- banks borrow more on demand debt and short term debt, but provide more long term loans. In other words; banks borrow short and lend long. Bank can do this because they can aggregate issues (e.g. accepting deposits and issuing banknotes) and redemptions (e.g. withdrawals and redemptions of banknotes), maintain reserves of cash, invest in marketable securities that can be readily converted to cash if needed, and raise replacement funding as needed from various sources (e.g. wholesale cash markets and securities markets) because they have a high and more well known credit quality than most other borrowers.

Law of banking

Banking law is based on a contractual analysis of the relationship between the **bank** and the **customer**. The definition of bank is given above, and the definition of customer is any person for whom the bank agrees to conduct an account.

The law implies rights and obligations into this relationship as follows:

1. The bank account balance is the financial position between the bank and the customer, when the account is in credit, the bank owes the balance to the customer, when the account is overdrawn, the customer owes the balance to the bank.
2. The bank engages to pay the customer's cheques up to the amount standing to the credit of the customer's account, plus any agreed overdraft limit.
3. The bank may not pay from the customer's account without a mandate from the customer, e.g. a cheque drawn by the customer.
4. The bank engages to promptly collect the cheques deposited to the customer's account as the customer's agent, and to credit the proceeds to the customer's account.
5. The bank has a right to combine the customer's accounts, since each account is just an aspect of the same credit relationship.
6. The bank has a lien on cheques deposited to the customer's account, to the extent that the customer is indebted to the bank.
7. The bank must not disclose the details of the transactions going through the customer's account unless the customer consents, there is a public duty to disclose, the bank's interests require it, or under compulsion of law.

8. The bank must not close a customer's account without reasonable notice to the customer, because cheques are outstanding in the ordinary course of business for several days.

These implied contractual terms may be modified by express agreement between the customer and the bank. The statutes and regulations in force in the jurisdiction may also modify the above terms and/or create new rights, obligations or limitations relevant to the bank-customer relationship.

Entry regulation

Main article: Banking regulation

Currently in most jurisdictions commercial banks are regulated by government entities and require a special bank license to operate.

Usually the definition of the business of banking for the purposes of regulation is extended to include acceptance of deposits, even if they are not repayable to the customer's order, however money lending, by itself, is generally not included in the definition.

Unlike most other regulated industries, the regulator is typically also a participant in the market, i.e. government owned bank (a central bank). Central banks also typically have a monopoly on the business of issuing banknotes. However, in some countries this is not the case, e.g. in the UK the Financial Services Authority licenses banks and some commercial banks, such as the Bank of Scotland, issue their own banknotes in competition with the Bank of England, the UK government's central bank.

Some types of entity may be partly or wholly exempt from bank license requirements and are regulated by separate regulators, e.g. building societies and credit unions.

The requirements for the issue of a bank license vary between jurisdictions but typically include:

1. Minimum capital
2. Minimum capital ratio
3. 'Fit and Proper' requirements for the bank's controllers, owners, directors, and/or senior officers
4. Approval of the bank's business plan as being sufficiently prudent and plausible.

Banking channels

Banks offer many different channels to access their banking and other services:

- A branch, banking centre or financial centre is a retail location where a bank or financial institution offers a wide array of face-to-face service to its customers.
- ATM is a computerized telecommunications device that provides a financial institution's customers a method of financial transactions in a public space without the need for a human clerk or bank teller. Most banks now have more ATMs than branches, and ATMs are providing a wider range of services to a wider range of users. For example in Hong Kong, most ATMs enable anyone to deposit cash to any customer of the bank's account by feeding in the notes and entering the account number to be credited. Also, most ATMs enable card holders from other banks to get their account balance and withdraw cash, even if the card is issued by a foreign bank.
- Mail is part of the postal system which itself is a system wherein written documents typically enclosed in envelopes, and also small packages containing other matter, are delivered to destinations around the world. This can be used to deposit cheques and to send orders to the bank to pay money to third parties. Banks also normally use mail to deliver periodic account statements to customers.
- Telephone banking is a service provided by a financial institution which allows its customers to perform transactions over the telephone. This normally includes bill payments for bills from major Creditors (e.g. for electricity).
- Online banking is a term used for performing transactions, payments etc. over the Internet through a bank, credit union or building society's secure website.

Types of banks

Banks' activities can be divided into retail banking, dealing directly with individuals and small businesses; business banking, providing services to mid-market business; corporate banking, directed at large business entities; private banking, providing wealth management services to high net worth individuals and families; and investment banking, relating to activities on the financial markets. Most banks are profit-making, private enterprises. However, some are owned by government, or are non-profits.

Central banks are normally government owned banks, often charged with quasi-regulatory responsibilities, e.g. supervising commercial banks, or controlling the cash interest rate. They generally provide liquidity to the banking system and act as the lender of last resort in event of a crisis.

Types of retail banks





National Bank of the Republic, Salt Lake City 1908



National Copper Bank, Salt Lake City 1911

- Commercial bank: the term used for a normal bank to distinguish it from an investment bank. After the Great Depression, the U.S. Congress required that banks only engage in banking activities, whereas investment banks were limited to capital market activities. Since the two no longer have to be under separate ownership, some use the term "commercial bank" to refer to a bank or a division of a bank that mostly deals with deposits and loans from corporations or large businesses.
- Community Banks: locally operated financial institutions that empower employees to make local decisions to serve their customers and the partners
- Community development banks: regulated banks that provide financial services and credit to under-served markets or populations.
- Postal savings banks: savings banks associated with national postal systems.
- Private banks manage the assets of high net worth individuals.
- Offshore banks: banks located in jurisdictions with low taxation and regulation. Many offshore banks are essentially private banks.
- Savings bank: in Europe, savings banks take their roots in the 19th or sometimes even 18th century. Their original objective was to provide easily accessible savings products to all strata of the population. In some countries, savings banks were created on public initiative, while in others socially committed individuals created foundations to put in place the necessary infrastructure. Nowadays, European savings banks have kept their focus on retail banking: payments, savings products, credits and insurances for individuals or small and medium-sized enterprises. Apart from this retail focus, they also differ from commercial banks by their broadly decentralized distribution network, providing local and regional outreach and by their socially responsible approach to business and society.
- Building societies and Land-banks: conduct retail banking.
- Ethical banks: banks that prioritize the transparency of all operations and make only what they consider to be socially-responsible investments.
- Islamic banks: Banks that transact according to Islamic principles.

Types of investment banks

- Investment banks "underwrite" (guarantee the sale of) stock and bond issues, trade for their own accounts, make markets, and advise corporations on capital markets activities such as mergers and acquisitions.
- Merchant banks were traditionally banks which engaged in trade finance. The modern definition, however, refers to banks which provide capital to firms in the form of shares rather than loans. Unlike venture capital firms, they tend not to invest in new companies.

Both combined

- Universal banks, more commonly known as financial services companies, engage in several of these activities. For example, First Bank (a very large bank) is involved in commercial and retail lending, and its subsidiaries in tax-havens offer offshore banking services to customers in other countries. Other large financial institutions are similarly diversified and engage in multiple activities. In Europe and Asia, big banks are very diversified groups that, among other services, also distribute insurance, hence the term bancassurance is the term used to describe the sale of insurance products in a bank. The word is a combination of "banque or bank" and "assurance" signifying that both banking and insurance are provided by the same corporate entity.

Other types of banks

Islamic banking

- Islamic banks adhere to the concepts of Islamic law. Islamic banking revolves around several well established concepts which are based on Islamic canons. Since the concept of interest is forbidden in Islam, all banking activities must avoid interest. Instead of interest, the bank earns profit (mark-up) and fees on financing facilities that it extends to the customers.

Banks in the economy

Size of global banking industry

Worldwide assets of the largest 1,000 banks grew 16.3% in 2006/2007 to reach a record \$74.2 trillion. This follows a 5.4% increase in the previous year. EU banks held the largest share, 53%, up from 43% a decade earlier. The growth in Europe's share was mostly at the expense of Japanese banks whose share more than halved during this period from 21% to 10%. The share of US banks remained relatively stable at around 14%. Most of the remainder was from other Asian and European countries. .¹⁸¹

The US had by far the most banks (7,540 at end-2005) and branches (75,000) in the world. The large number of banks in the US is an indicator of its geography and regulatory structure, resulting in a large number of small to medium sized institutions in its banking system. Japan had 129 banks and 12,000 branches. In 2004, Germany, France, and Italy had more than 30,000 branches each—more than double the 15,000 branches in the UK.^[9]

Bank crisis

Banks are susceptible to many forms of risk which have triggered occasional systemic crises. Risks include liquidity risk (the risk that many depositors will request withdrawals beyond available funds), credit risk (the risk that those who owe money to the bank will not repay), and interest rate risk (the risk that the bank will become unprofitable if rising interest rates force it to pay relatively more on its deposits than it receives on its loans), among others.

Banking crises have developed many times throughout history when one or more risks materialize for a banking sector as a whole. Prominent examples include the U.S. Savings and Loan crisis in 1980s and early 1990s ^[10] the Japanese banking crisis during the 1990s, the bank run that occurred during the Great Depression, and the recent liquidation by the central Bank of Nigeria, where about 25 banks were liquidated.

Numerous banks have suffered as a result of the Sub-prime mortgage crisis, which has occurred on a global scale, affecting investment banks such as Lehman Brothers in the USA and retail banks such as Northern Rock in the UK. In January 2009, several major UK banks such as Lloyds TSB and Barclays Bank, suffered severe falls in their London stock exchange share prices as a result of a drop in investor confidence of the true asset values of those banks.

Challenges within the banking industry



The examples and perspective in this article **may not represent a worldwide view of the subject**.



This section does not cite any references or sources.

The banking industry is a highly regulated industry with detailed and focused regulators. All banks with FDIC-insured deposits have the FDIC as a regulator; however, for examinations, the Federal Reserve is the primary federal regulator for Fed-member state banks; the Office of the Comptroller of the Currency (“OCC”) is the primary federal regulator for national banks; and the Office of Thrift Supervision, or OTS, is the primary federal regulator for thrifts. State non-member banks are examined by the state agencies as well as the FDIC. National banks have one primary regulator—the OCC.

Each regulatory agency has their own set of rules and regulations to which banks and thrifts must adhere.

The Federal Financial Institutions Examination Council (FFIEC) was established in 1979 as a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions. Although the FFIEC has resulted in a greater degree of regulatory consistency between the agencies, the rules and regulations are constantly changing.

In addition to changing regulations, changes in the industry have led to consolidations within the Federal Reserve, FDIC, OTS and OCC. Offices have been closed, supervisory regions have been merged, staff levels have been reduced and budgets have been cut. The remaining regulators face an increased burden with increased workload and more banks per regulator. While banks struggle to keep up with the changes in the regulatory environment, regulators struggle to manage their workload and effectively regulate their banks. The impact of these changes is that banks are receiving less hands-on assessment by the regulators, less time spent with each institution, and the potential for more problems slipping through the cracks, potentially resulting in an overall increase in bank failures across the United States.

The changing economic environment has a significant impact on banks and thrifts as they struggle to effectively manage their interest rate spread in the face of low rates on loans, rate competition for deposits and the general market changes, industry trends and economic fluctuations. It has been a challenge for banks to effectively set their growth strategies with the recent economic market. A rising interest rate environment may seem to help financial institutions, but the effect of the changes on consumers and businesses is not predictable and the challenge remains for banks to grow and effectively manage the spread to generate a return to their shareholders.

The management of the banks' asset portfolios also remains a challenge in today's economic environment. Loans are a bank's primary asset category and when loan quality becomes suspect, the foundation of a bank is shaken to the core. While always an issue for banks, declining asset quality has become a big problem for financial institutions. There are several reasons for this, one of which is the lax attitude some banks have adopted because of the years of "good times." The potential for this is exacerbated by the reduction in the regulatory oversight of banks and in some cases depth of management. Problems are more likely to go undetected, resulting in a significant impact on the bank when they are recognized. In addition, banks, like any business, struggle to cut costs and have consequently eliminated certain expenses, such as adequate employee training programs.

Banks also face a host of other challenges such as aging ownership groups. Across the country, many banks' management teams and board of directors are aging. Banks also face ongoing pressure by shareholders, both public and private, to achieve earnings and growth projections. Regulators place added pressure on banks to manage the various categories of risk. Banking is also an extremely competitive industry. Competing in the

financial services industry has become tougher with the entrance of such players as insurance agencies, credit unions, check cashing services, credit card companies, etc.

As a reaction, banks have developed their activities in financial instruments, through financial market operations such as brokerage and trading and become big players in such activities.

Profitability

A bank generates a profit from the differential between the level of interest it pays for deposits and other sources of funds, and the level of interest it charges in its lending activities. This difference is referred to as the *spread* between the cost of funds and the loan interest rate. Historically, profitability from lending activities has been cyclical and dependent on the needs and strengths of loan customers. In recent history, investors have demanded a more stable revenue stream and banks have therefore placed more emphasis on transaction fees, primarily loan fees but also including service charges on an array of deposit activities and ancillary services (international banking, foreign exchange, insurance, investments, wire transfers, etc.). Lending activities, however, still provide the bulk of a commercial bank's income.

In the past 10 years American banks have taken many measures to ensure that they remain profitable while responding to increasingly changing market conditions. First, this includes the Gramm-Leach-Bliley Act, which allows banks again to merge with investment and insurance houses. Merging banking, investment, and insurance functions allows traditional banks to respond to increasing consumer demands for "one-stop shopping" by enabling cross-selling of products (which, the banks hope, will also increase profitability). Second, they have expanded the use of risk-based pricing from business lending to consumer lending, which means charging higher interest rates to those customers that are considered to be a higher credit risk and thus increased chance of default on loans. This helps to offset the losses from bad loans, lowers the price of loans to those who have better credit histories, and offers credit products to high risk customers who would otherwise been denied credit. Third, they have sought to increase the methods of payment processing available to the general public and business clients. These products include debit cards, pre-paid cards, smart cards, and credit cards. They make it easier for consumers to conveniently make transactions and smooth their consumption over time (in some countries with under-developed financial systems, it is still common to deal strictly in cash, including carrying suitcases filled with cash to purchase a home). However, with convenience of easy credit, there is also increased risk that consumers will mismanage their financial resources and accumulate excessive debt. Banks make money from card products through interest payments and fees charged to consumers and transaction fees to companies that accept the cards.