

- 1.) According to the video, banking started on the island of _____
- 2.) Is there more money in (any and every) country's economy than all of the coins minted and bills printed? Yes/No
- 3.) How does a bank create money in an economy? Hint: See the skit starting at 3:01

- 4.) Go to the Inflation segment starting at 5:42 and ending at 7:28. Explain what caused inflation in Spain after gold and silver was discovered in the New World.

- 5.) At 6:54 in the video, Mr. K. states that, "the one group of people who get saved when there is massive inflation is people who have debt". Please explain.

- 6.) Starting at 7:29 in the video is a segment that explains how banks make money. Please explain how banks make money below.

- 7.) At 7:58 in the video the narrator explains a scenario where customers all tried to get their money out of the bank at once. Why was this a problem?

- 8.) Describe the role of the Federal Reserve Bank.

The Development of Modern Banking

Study Guide

Main Idea

The Federal Reserve System serves the monetary needs of the federal government and controls the monetary system.

Reading Strategy

Graphic Organizer As you read the section, complete a graphic organizer similar to the one below by listing at least three kinds of depository institutions.



Key Terms

Federal Reserve System, central bank, Federal Reserve note, run on the bank, bank holiday, commercial

bank, demand deposit account (DDA), thrift institution, mutual savings bank (MSB), savings bank, NOW accounts, savings and loan association (S&L), credit union, share draft account, deregulation, creditor

Objectives

After studying this section, you will be able to:

1. **Relate** the effects of Depression-era bank failures on deposit insurance creation.
2. **Identify** three other forms of depository institutions.
3. **Describe** the reasons for the S&L crisis in the 1980s.

Applying Economic Concepts

Demand Deposit Accounts You may think that checking accounts are pretty useful. Read to find out how they replaced the carrying of large amounts of cash to make life easier for everyone.

Cover Story

Suspicious Internet Banking

Today more and more banks are offering financial services via the Internet. While the vast majority of these are entirely legitimate, the sad fact is that a few unscrupulous people may take advantage of the anonymity of the Internet to perpetuate fraud. . . . [W]e



More banks go online.

[The FDIC] offer two items you may find helpful in determining . . . suspicious Web sites.

[The first is a] searchable database [that] will help you determine if an institution has a legitimate charter and is a member of the FDIC.

[The second is a] special alert financial institution letter . . . pertaining to unauthorized banking operations currently identified. . . .

—FDIC, June 10, 1999


Banks fulfill two distinct needs. They provide a safe place for people to deposit their money, and they lend excess funds to individuals and businesses temporarily in need of cash. This can only happen if the nation has a strong banking system.

Revising the Banking System



In 1863, the federal government strengthened the financial system by passing the National Banking Act. It set up a system of nationally chartered and inspected banks. Yet problems persisted as financial crises and recessions marked the next half century. Each crisis led to calls for reform, but when the crisis ended, the protests faded away. Finally, when consumer and commercial credit dried up during the panic of 1907, the need for reform could no longer be ignored. The government set up a commission to formulate a plan for a new system.

The Federal Reserve System

 Reform came in 1913 when Congress created the **Federal Reserve System**, or Fed, as the nation's first true central bank. A **central bank** is a bank that can lend to other banks in times of need.

To ensure membership in the Fed, all national banks were required, and all state-chartered banks were eligible, to become “members”—or part owners—of the Fed. Because the Fed was organized as a corporation, any bank that joined had to purchase shares of stock in the system, just as a private individual purchases shares in a regular corporation. As a result, privately-owned banks own the Federal Reserve System, not the government.

Despite its private ownership, the Fed is publicly controlled. The president appoints, subject to congressional approval, the Fed's Board of Governors and its chairperson.

Finally, **Federal Reserve notes**—paper currency issued by the Fed that eventually replaced all other types of federal currency—were added to the money supply. Federal Reserve notes were backed by gold when first issued in 1914, but became inconvertible fiat money after 1934.

Banking During the Great Depression

Despite the reforms many banks were only marginally sound during the 1920s. Part of the reason was the over-expansion in banking that took place

between 1880 and 1921. Although some consolidation occurred between 1921 and 1929, the banking industry was overextended when the Great Depression began in 1929.

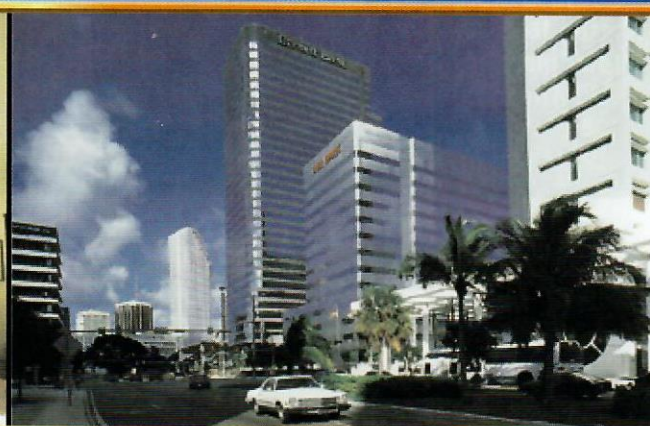
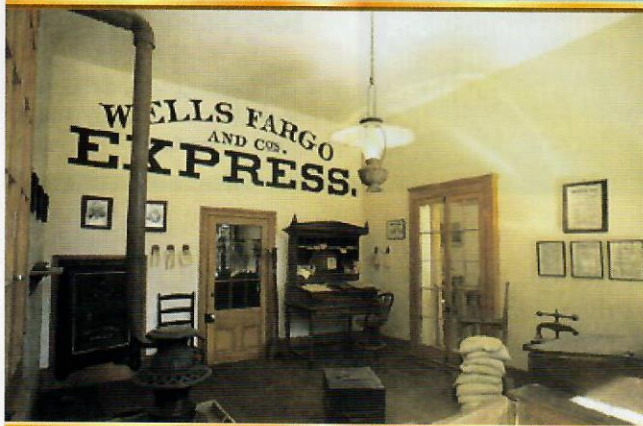
As **Figure 11.2** shows, the number of bank failures during the 1930s was staggering. At the start of the Depression, about 25,500 banks existed—none of which had deposit insurance for their customers. As a result, concern about the safety of bank deposits often caused a **run on the bank**—a rush by depositors to withdraw their funds from a bank before it failed. This made the situation even worse and caused more banks to fail.

To ease the situation, on March 5, 1933, President Roosevelt announced a **bank holiday**—a brief period during which every bank in the country was required to close. Several days later, after Congress passed legislation that strengthened banking, most banks were allowed to reopen. The Great Depression took its toll, however, and by 1934 more than 10,000 banks had closed or merged with stronger partners.

Federal Deposit Insurance

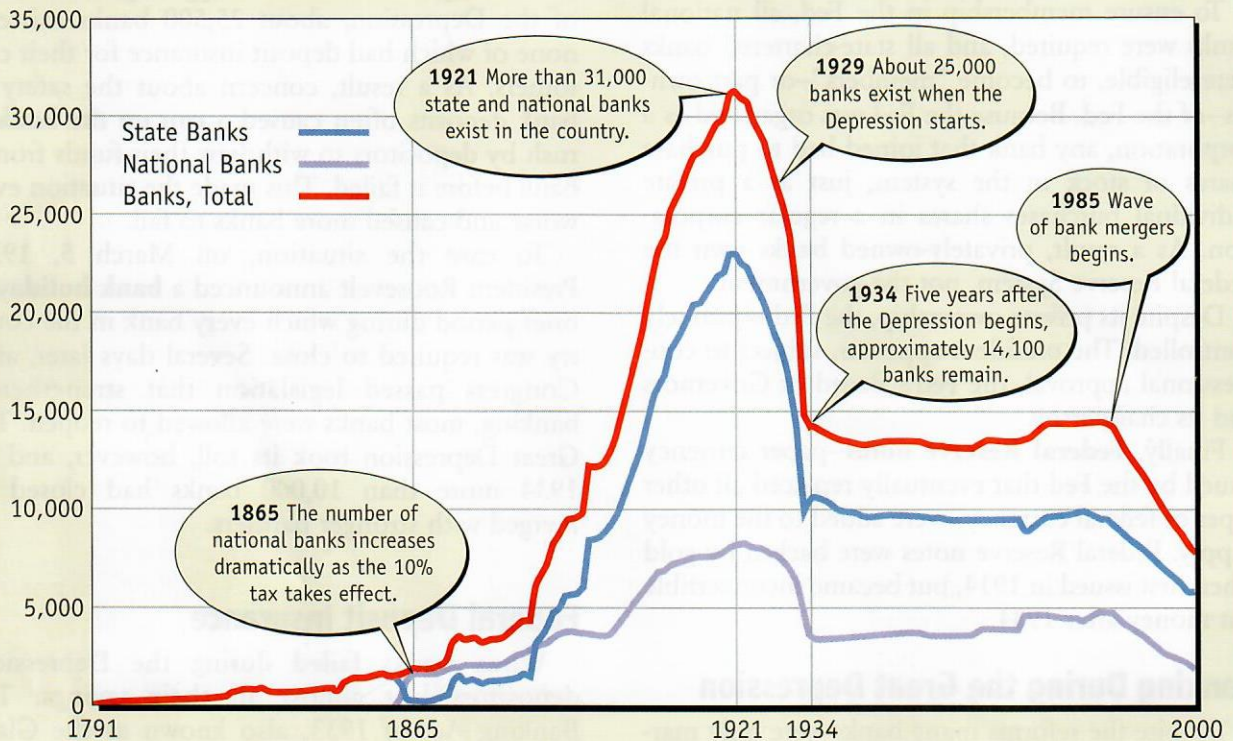
When banks failed during the Depression, depositors lost almost all their savings. The Banking Act of 1933, also known as the Glass-Steagall Act, was passed to strengthen the banking industry. The act also created the Federal Deposit

Banks



Purposes From early times on, banks provided safe storage facilities, interest payments on deposits, money transfers, and loans. *What is the purpose of the Federal Deposit Insurance Corporation?*

Number of State and National Banks



Source: Federal Deposit Insurance Corporation and *Historical Statistics of the United States, Colonial Times to 1970*

Using Graphs The number of banks in the United States grew rapidly after 1880 and peaked in 1921. A period of mergers and consolidations took place from 1921 to 1929, after which the Great Depression took its toll. The number of banks remained relatively constant from 1933 to 1985, when another wave of mergers took place. **What can you infer about the ratio of state banks to national banks?**

ECONOMICS
Online

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Insurance Corporation (FDIC) to insure customer deposits in the event of a bank failure. The initial coverage was only \$2,500 per account, but it has since been increased to a maximum of \$100,000 for one person at one bank.

The insurance did little for those who lost their savings before 1934, but it has provided a sense of security in banking ever since. After the FDIC was

created, people worried less about the safety of their deposits, reducing the number of runs on a bank.

Today, protection provided by the FDIC goes far beyond deposit insurance. As you read in the cover story, the FDIC aggressively pursues ways to protect consumers against fraudulent banks—even those not insured by the FDIC.

Other Depository Institutions

 Most of the early U.S. banks were **commercial banks**—banks that catered to the interests of business and commerce. They had the power to issue checking accounts. Checking accounts are also called **demand deposit accounts (DDAs)**—accounts whose funds could be removed by simply writing a check without prior approval from the depository institution. Other financial institutions, called **thrift institutions**, or thrifts, accepted the deposits of small investors but did not have DDAs until the mid-1970s.

Savings Banks

One of the oldest thrift institutions in the United States is the **mutual savings bank (MSB)**, a depositor-owned financial organization operated only for the benefit of its depositors. Later, many MSBs decided to sell stock to raise additional financial capital. These institutions then became **savings banks** because they were no longer mutually owned by depositors.

Mutual savings banks got their start in the late 1700s. At that time, commercial banks were not interested in the accounts of small wage earners. Savings banks emerged to fill that need and became very popular with consumers.

By the mid-1800s, commercial banks, along with the savings and loan associations, began to compete more heavily with the savings banks. As a result, savings banks did not spread beyond their foothold in the industrial northeast and the Pacific northwest.

STANDARD & POOR'S

INFOBYTE

Interest Rates Interest rates represent the time value of money. In other words, a dollar today is worth more than a dollar one year from now. To compensate investors for the risks of investment, interest rates must take into account inflation, liquidity, credit, and other risks.

Even so, savings banks had a powerful influence. In 1972, the Consumer's Savings Bank of Worcester, Massachusetts introduced Negotiable Order of Withdrawal, or **NOW accounts**, a type of checking account that pays interest. Because commercial banks held most checking accounts at the time, they strongly opposed NOW accounts. NOW accounts proved popular, however, and they were offered nationwide after 1980.

Savings and Loan Associations

Another type of financial institution is the **savings and loan association (S&L)**—a depository institution that invests the majority of its funds in home mortgages. S&Ls began as cooperative clubs for homebuilders in the 1800s. The association's members promised to deposit a certain sum regularly into the association. Members then took turns borrowing money to build a home.


Later, in the 1930s, the Federal Home Loan Bank Board was created to supervise and regulate individual savings and loan associations. The Federal Savings and Loan Insurance Corporation (FSLIC), a federal government agency like the FDIC that serves commercial bankers, was also created to insure savings and loan deposits.

Credit Unions

A fourth type of depository institution is the **credit union**—a nonprofit service cooperative that is owned by, and operated for, the benefit of its members. Costs are generally low because a sponsor such as the members' place of employment often provides management, clerical help, and office facilities.

Because most credit unions are organized around an employer, contributions generally are deducted directly from a worker's paycheck. More recently, **share draft accounts**—or interest-earning checking accounts issued by credit unions—were introduced to compete with NOW accounts.

Crisis and Reform in the 1980s

 Because of the massive banking failures during the Great Depression, financial institutions were closely regulated from 1933 through the 1970s. The regulations even applied to maximum

rates of interest that could be paid on checking and savings accounts, as well as to restrictions on how and to whom the institutions could lend their funds.

By the late 1970s, most financial institutions were calling for relief from federal regulations. When Ronald Reagan was elected president in 1980, the political climate changed, allowing **deregulation**—the removal or relaxation of government restrictions on business.

Deregulation reduced the differences between competing financial institutions. First, the requirement that set maximum interest rates on savings accounts was phased out. This action eliminated the advantage that savings banks and S&Ls had over commercial banks when it came to paying higher interest rates on savings accounts.

Second, NOW accounts could be offered on a nationwide basis by any type of financial institution. This provision eliminated the advantage that commercial banks had with their check-issuing powers.

Third, all depository institutions could borrow from the Federal Reserve System in times of need, a privilege previously reserved for commercial banks. In return, all depository institutions were required to set aside a larger part of their customers' deposits in the form of reserves.

The Savings and Loan Crisis

An S&L crisis unfolded slowly but surely during the 1980s. In 1980 the United States had 4,600 S&Ls. By mid-1988, bankruptcies and mergers reduced the number to about 3,000. By the early 1990s, fewer than 2,000 institutions survived.

Deregulation was one of the reasons for the crisis. Savings and loan institutions were used to having the government set their interest rates and determine what types of loans they could make. Most S&Ls, therefore, were not well prepared to face real competition in the marketplace.

Another problem was high interest rates. Most S&Ls made long-term, low-interest loans to homeowners in the early 1970s. When interest rates reached record levels in the early 1980s, S&Ls ended up paying more on funds deposited with them than they earned on the loans they already made.

A third problem was the relatively small capital reserves kept by the S&Ls to absorb bad loans—reserves about half the size that commercial banks kept. This meant that several bad loans could force an S&L to go out of business, rather than be absorbed by the capital accounts.

Deregulation also resulted in fewer federal inspectors to make sure the rules and regulations were followed. As a result, a few institutions were able to engage in fraud on a scale seldom seen before.

Reforming the Thrift Industry

The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) was passed in 1989. This act abolished the independence of the savings and loan industry and is regarded as the most significant financial legislation since the Depression.

Many S&Ls were profitable during the crisis. These institutions were allowed to continue operations, and many even kept the words *savings and loan association* in their titles. Others, however, chose to

Careers

Bank Teller

When you go to a bank, a bank teller often handles your money. The bank teller's job is to process a customer's transactions.

The Work

Bank tellers handle a wide range of banking transactions, including cashing checks, accepting deposits and loan payments, and processing withdrawals. Bank tellers may

sell savings bonds and traveler's checks, and handle foreign currencies or commercial accounts. They are trained to explain the various types of accounts and financial services the bank offers.

Qualifications

Tellers need an aptitude for using computers, and they must be quick, accurate, and honest. Good numerical, clerical, and communication skills are a must. A bank teller's job is an entry-level position. After a few years, a bank teller can be promoted to be a personal banker or into a management position.

change their name to distance themselves from the crisis that had tarnished so many reputations.

Even so, the cost of the thrift crisis to taxpayers was enormous, amounting about \$300 billion. This amounted to approximately \$1,200 for every man, woman, and child in America.

Dealing With Failed Banks

Bank failures were also a problem in the 1980s. If a bank is in danger of collapse, the FDIC can seize the bank and either sell it to a stronger one or liquidate it and pay off the depositors. The forced sale or liquidation is done in secrecy to prevent panic withdrawals and to prevent shareholders from selling their worthless stock to unsuspecting investors.

Either way, depositors have little to fear because they are covered up to the \$100,000 FDIC insurance limit. If an account has more than this, the depositor may go to court as a **creditor**—a person or institution to whom money is owed—and sue the bank's owners to recover the rest.

Banks fail for many reasons, but poor management is the primary cause. Some banks make loans

without adequate collateral, others fail to keep expenses under control, and still others may be victims of a weak economy. The reforms instituted as a result of the S&L crisis, however, have made all financial institutions safer.

Change in the 1990s

The 1980s were so turbulent that caution became the watchword of the 1990s. The thrift crisis was largely over, and the surviving financial institutions adopted more conservative lending policies, which helped them return to profitability.

Along with stronger federal regulations, all financial institutions were required to strengthen their capital reserves. The FDIC, as we saw in the cover story, even provides innovative ways to help the public discover and prevent abuses by fraudulent financial institutions.

Two trends that emerged at the beginning of the decade were in full swing by the end of the century. One was the improving health of all financial institutions. The second was the continued erosion of historical differences among the commercial banks, savings banks, S&Ls, and credit unions.

Section 3 Assessment

Checking for Understanding

- 1. Main Idea** Why was the Federal Reserve System created?
- 2. Define** Federal Reserve System, central bank, run on the bank, bank holiday, commercial bank, demand deposit account (DDA), thrift institution, mutual savings bank (MSB), savings bank, NOW accounts, savings and loan association (S&L), credit union, share draft accounts, deregulation, creditor.
- 3. Explain** why the National Banking System was created.
- 4. Explain** why deposit insurance developed in the 1930s.
- 5. Identify** three depository institutions.
- 6. Describe** four factors contributing to the S&L crisis.

Applying Economic Concepts

- 7. Demand Deposit Accounts** Adam Smith argued that a competitive economy functions best when everyone pursues his or her own best interests. Explain how the self-interest of state-chartered banks in 1865 led to the development of demand deposit accounts.

Critical Thinking

- 8. Drawing Conclusions** The FDIC insures deposits up to \$100,000. What would you do if you had \$400,000 you wanted to deposit and insure?
- 9. Summarizing Information** What is a demand deposit account?



Practice and assess key social studies skills with the *Glencoe Skillbuilder Interactive Workbook, Level 2*.

Name: _____

Lesson 55 Part 2

Define the following terms:	
Federal Reserve System:	Mutual Savings Bank:
Central Bank:	Credit Union:
Run On The Bank:	Thrift Institution:
Bank Holiday:	Deregulation:
Demand Deposit Account:	Creditor:

1.) Explain why the National Banking System was created.

2.) Explain why deposit insurance developed in the 1930's.

3.) Identify three depository institutions.

4.) Describe four factors contributing to the S&L crisis.
