



## INSTITUTIONS THAT MATCH UP SAVERS AND BORROWERS HELP ENSURE THAT ECONOMIES FUNCTION SMOOTHLY.

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You have got \$1,000 you don't need for, say, a year and want to earn income from the money until then. Or you want to buy a house and need to borrow \$100,000 and pay it back over 30 years. It would be difficult, if not impossible, for someone acting alone to find either a potential borrower who needs exactly \$1,000 for a year or a lender who can spare \$100,000 for 30. That's where banks come in.

Although banks do many things, their primary role is to take in funds—called deposits—from those with money, pool them, and lend them to those who need funds. Banks are intermediaries between depositors (who lend money to the bank) and borrowers (to whom the bank lends money). The amount banks pay for deposits and the income they receive on their loans are both called interest. Depositors can be individuals and households, financial and nonfinancial firms, or national and local governments. Borrowers are, well, the same. Deposits can be available on demand (a checking account, for example) or with some restrictions (such as savings and time deposits).

Making loans-While at any given moment some depositors need their money, most do not. That enables banks to use shorter-term deposits to make longer-term loans. The process involves *maturity transformation*—converting short-term liabilities (deposits) to long-term assets (loans). Banks pay depositors less than they receive from



borrowers, and that difference accounts for the bulk of banks' income in most countries.

Banks can complement traditional deposits as a source of funding by directly borrowing in the money and capital markets. They can issue securities such as commercial paper or bonds; or they can temporarily lend securities they already own to other institutions for cash—a transaction often called a repurchase agreement (repo). Banks can also package the loans they have on their books into a security and sell this to the market (a process called *liquidity transformation* and *securitization*) to obtain funds they can relend. A bank's most important role may be matching up creditors and borrowers, but banks are also essential to the *domestic and international payments system*—and they *create money*.

Not only do individuals, businesses, and governments need somewhere to deposit and borrow money, they need to move funds around—for example, from buyers to sellers or employers to employees or taxpayers to governments. Here too banks play a central role. They process payments, from the tiniest of personal checks to large-value electronic payments between banks. The payments system is a complex network of local, national, and international banks and often involves government central banks and private clearing facilities that match up what banks owe each other. In many cases payments are processed nearly instantaneously. The payments system also includes credit and debit cards. A well-operating payments system is a prerequisite for an efficiently performing economy, and breakdowns in the payments system are likely to disrupt trade—and, therefore, economic growth—significantly.

Creating money-Banks also create money. They do this because they must hold on reserve, and not lend out, some portion of their deposits—either in cash or in securities that can be quickly converted to cash. The amount of those reserves depends both on the bank's assessment of its depositors' need for cash and on the requirements of bank



regulators, typically the central bank—a government institution that is at the center of a country’s monetary and banking system. Banks keep those required reserves on deposit with central banks, such as the U.S. Federal Reserve, the Bank of Japan, and the European Central Bank. Banks create money when they lend the rest of the money depositors give them. This money can be used to purchase goods and services and can find its way back into the banking system as a deposit in another bank, which then can lend a fraction of it. The process of relending can repeat itself a number of times in a phenomenon called the multiplier effect. The size of the multiplier—the amount of money created from an initial deposit—depends on the amount of money banks must keep on reserve.

Banks also lend and recycle excess money within the financial system and create, distribute, and trade securities.

Banks have several ways of making money besides pocketing the difference (or spread) between the interest they pay on deposits and borrowed money and the interest they collect from borrowers or securities they hold. They can earn money from:

- income from securities they trade; and
- fees for custome services, such as checking accounts, financial and investment banking, loan servicing, and the origination, distribution, and sale of other financial products, such as insurance and mutual funds.

Banks earn on average between 1 and 2 percent of their assets (loans and securities). This is commonly referred to as a bank’s return on assets.

Transmitting monetary policy-Banks also play a central role in the transmission of monetary policy, one of the government’s most important tools for achieving economic growth without inflation. The central bank controls the money supply at the national level, while banks facilitate the flow of money in the markets within which



they operate. At the national level, central banks can shrink or expand the money supply by raising or lowering banks' reserve requirements and by buying and selling securities on the open market with banks as key counterparties in the transactions. Banks can shrink the money supply by putting away more deposits as reserves at the central bank or by increasing their holdings of other forms of liquid assets—those that can be easily converted to cash with little impact on their price. A sharp increase in bank reserves or liquid assets—for any reason—can lead to a “credit crunch” by reducing the amount of money banks have to lend, which can lead to higher borrowing costs as customers pay more for scarcer bank funds. A credit crunch can hurt economic growth.

Banks can fail, just like other firms. But their failure can have broader ramifications—hurting customers, other banks, the community, and the market as a whole. Customer deposits can be frozen, loan relationships can break down, and lines of credit that businesses draw on to make payrolls or pay suppliers may not be renewed. In addition, one bank failure can lead to other bank failures.

Banks' vulnerabilities arise primarily from three sources:

- a high proportion of short-term funding such as checking accounts and repos to total deposits. Most deposits are used to finance longer-term loans, which are hard to convert into cash quickly;
- a low ratio of cash to assets; and
- a low ratio of capital (assets minus liabilities) to assets.

Depositors and other creditors can demand payment on checking accounts and repos almost immediately. When a bank is perceived—rightly or wrongly—to have problems, customers, fearing that they could lose their deposits, may withdraw their funds so fast that the small portion of liquid assets a bank holds becomes quickly



exhausted. During such a “run on deposits” a bank may have to sell other longer-term and less liquid assets, often at a loss, to meet the withdrawal demands. If losses are sufficiently large, they may exceed the capital a bank maintains and drive it into insolvency.

Essentially, banking is about confidence or trust—the belief that the bank has the money to honor its obligations. Any crack in that confidence can trigger a run and potentially a bank failure, even bringing down solvent institutions. Many countries insure deposits in case of bank failure, and the recent crisis showed that banks’ greater use of market sources of funding has made them more vulnerable to runs driven by investor sentiment than to depositor runs.

The need for regulation—Bank safety and soundness are a major public policy concern, and government policies have been designed to limit bank failures and the panic they can ignite. In most countries, banks need a charter to carry out banking activities and to be eligible for government backstop facilities—such as emergency loans from the central bank and explicit guarantees to insure bank deposits up to a certain amount. Banks are regulated by the laws of their home country and are typically subject to regular supervision. If banks are active abroad, they may also be regulated by the host country. Regulators have broad powers to intervene in troubled banks to minimize disruptions.

Regulations are generally designed to limit banks’ exposures to credit, market, and liquidity risks and to overall solvency risk. Banks are now required to hold more and higher-quality equity—for example, in the form of retained earnings and paid-in capital—to buffer losses than they were before the financial crisis. Large global banks must hold even more capital to account for the potential impact of their failure on the stability of the global financial system (also known as [systemic risk](#)). Regulations also



stipulate minimum levels of liquid assets for banks and prescribe stable, longer-term funding sources.

Regulators are reviewing the growing importance of institutions that provide bank-like functions but that are not regulated in the same fashion as banks—so-called shadow banks—and looking at options for regulating them. The recent financial crisis exposed the systemic importance of these institutions, which include finance companies, investment banks, and money market mutual funds.

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