Research Report

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Forum:	*General Assembly Second Committee: Economic and Financial*
Issue:	*The public function of banks*
Position:	*Deputy Chair*

Introduction

Nowadays people cannot imagine their lives without banks. We all have bank accounts, credit cards and now we can even pay using our mobile phone. We use "electronic money" more often than we actually see the "real money". In addition, mostly we are not able to buy a house, an apartment or some electronic device without loans. Banks have many functions and as we can see they have a huge contribution to our lifestyle and the way we live. The problem concerning the issue is what is going to happen if a bank goes bankrupt. What is going to happen with the economy and whole financial system as also what is going to happen with money that actually belongs to people. We should all think about how we can prevent this situation and how the money can be secured if a bankruptcy like this would occur.

Definition of Key Terms

Bank
An establishment authorized by a government to accept deposits, pay interest, clear checks, make loans, act as an intermediary in financial transactions and provide other financial services to its customers. These financial institutions are regulated by the national government or central bank.

Public function of banks
Mainly this is the process of making the economy run by lending to companies and making sure that consumers can pay and save money.

General Overview

History of banks
The term bank is derived from old Italian word *banca* or from a French word *banque*. Both of them mean a "Bench" or "money exchange table". This is because European money lenders and money changers used to show coins of different countries in big heaps on benches or tables in order to lend or exchange money.

The idea of banks began in 18th century BC in Babylon when people were taking loans made by the priests of the temple. The new functions of banks were introduced in 4th century BC in Greece and Rome. Banks were not only making loans but were also

accepting deposits and changing money from one currency to another as well as they were testing coins for their weight and purity. Even book transactions were engaged. In the 12th – 13th century there was a Christian prohibition on usury. The Jews and the knights Templar used their opportunity as European prosperity needed finance. One hundred years later the Jews were replaced by Lombards- bankers from north Italy as they were able to find a method to avoid the sin of usury. In the late 17th century the new invention gained acceptance. It was a cheque which is a bill of exchange between banks, payable by one of the banks to whoever holds and presents the cheque. During the 17th and 18th centuries, moneylenders transferred into private banks and also national banks developed. The oldest surviving bank is the Bank of Sweden founded in 1668. But the first bank that begin the permanent issue of banknotes was the Bank of England.

The biggest crisis in banking history was during the Great Depression. That is when banks began to fail as debtors defaulted on debt and depositors attempted to withdraw their deposits, triggering multiple bank runs. In a result, billions of dollars in assets were lost. Over 9.000 banks failed in the 1930s. During the Second World War, two powerful organization have been created: the International Monetary Fund (IMF) and the World Bank. The roots of modern banking can be traced back to 1960 when Charles Sanford joined Bankers Trust. During his tenure, which lasted until 1966, the bank pioneered a number of practices that would later become common in the industry, including the development of new ways to measure risk. In the 1960s, the first Automated Teller Machines (ATM) have been created. As well, ten years later electronic payment systems for both international and domestic payments have been introduced. During the first decade of the 21st century there was a major shift away from traditional banking to internet banking. Another big economic crisis took place during the Late-2000s.

There are two types of banks: commercial banks and retail banks. Moreover, there is an investment bank which engage in the issuance of the new securities to the public.

Functions of banks

A. <u>Primary functions of banks (also banking functions):</u>

1. **Accepting deposits such as:**

a) *Saving deposits*- created especially for the public, rate interest is rather low
b) *Fixed deposits*- money is being deposited at one time for a specific period, rate interest depends on the period of deposit.
c)*Current deposits*- this kind of account is created for businessmen, withdrawals are freely allowed, no interest is paid.
d)*Recurring deposits*- designed for salaried persons and petty traders, withdrawals are permitted only after the expiry of certain period but there is a higher rate of interest.

2. Granting Advances:

a) *Overdraft*- this operation is being made on current account, an amount is sanctioned as overdraft which can be withdrawn within a certain period, interest is charged on actual amount withdrawn. It is sanctioned to businessmen and firms.

b) *Cash Credits*- separate cash credit account is maintained, the client is allowed cash credit up to a specific limit fixed in advance, interest is charged on the amount withdrawn in excess of limit.

c) *Loans*- usually it is given to short term, repayment of money can be in the form of installments spread over a period of time, amount, interest is charged on the actual amount sanctioned, whether withdrawn or not, the rate of interest may be slightly lower than what is charged on overdrafts and cash credits.

d) *Discounting Bills*- the bank is able to advance money by discounting or by purchasing bills of exchange both domestic and foreign bills.

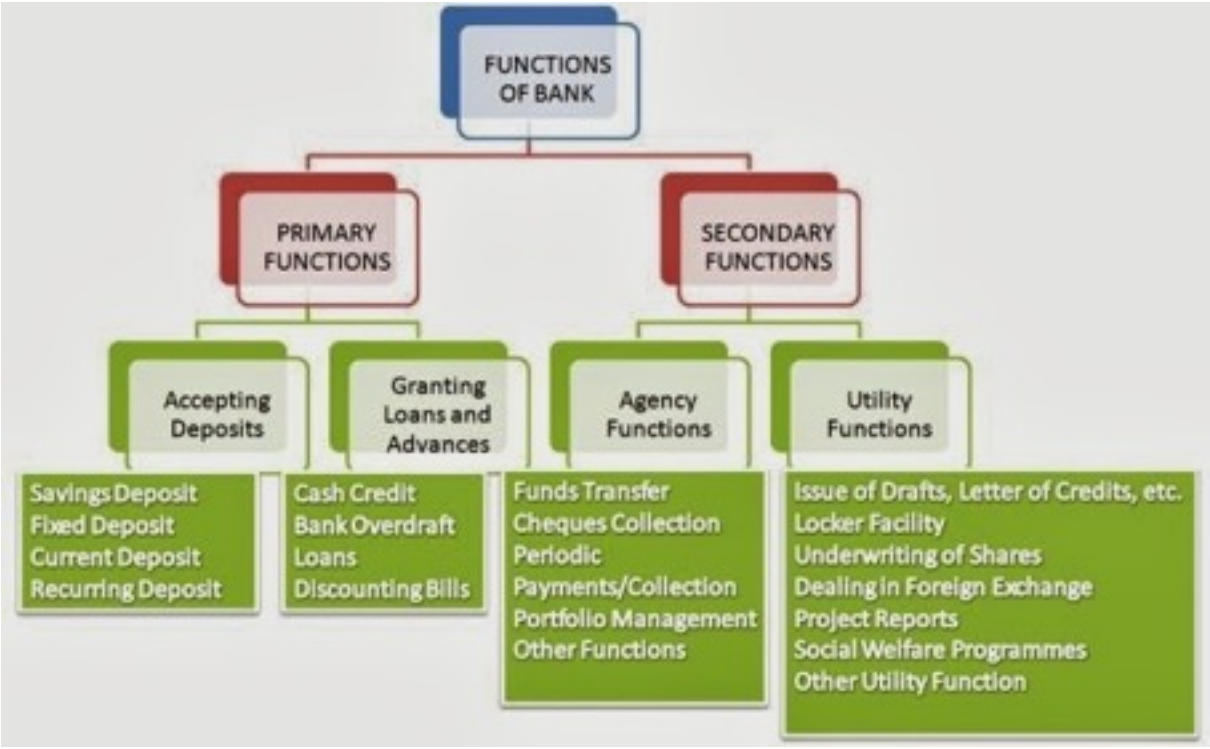
B. <u>Secondary functions (known also as non-banking functions):</u>

1. Agency functions:

a) *Funds Transfer*
b) *Cheques collection*
c) *Periodic Payments*
d) *Periodic Collection*
e) *Portfolio Management*
f) *Other functions*

2. Utility functions:

a) *Issue of Drafts, Letter of Credits, etc.*
b) *Locker Facility*
c) *Underwriting of Shares*
d) *Dealing in Foreign Exchange*
e) *Project Reports*
f) *Social Welfare Programmes*
g) *Other Utility functions.*



Problems after bankruptcy

As we all know, banks are a part of our financial system and current economy depends on them. Unluckily, these financial institutions are obviously trying to increase their profit. In order to do so, they invest in risky loans or projects. This deals might lead to bankruptcy. Therefore, governments support these banks so as to prevent from economic crashes. This means that a government cannot allow banks to declare bankruptcy and governments are forced to bail out the banks. Our problem is how to help the endanger of the public functions of banks if they go bankrupt.

Banks were always working this way. They are taking money from people (deposits) and then are investing it. What is actually the most frightening is that banks can legally extend more credit than they have cash. By making loans, banks are also able to create money. The Federal Reserve set that the reserve requirement (which can be held either in cash on hand or in the bank's reserve account with the Federal Reserve) is currently 3 percent to 10 percent of bank's total deposits.

The chances that banks will go bankrupt are rather small but there is always a risk. People are said to have too much faith in banks. The banking industry is also characterized by strong interconnections. If one bank fails, it can lead to bankruptcy of its partner. This makes the banking business more vulnerable to bankruptcies as people tend to speculate which bank will be next if one bank fails. Therefore, increasing the probability that another bank will fail. Consequently, citizens usually want to immediately withdraw their money frightened that they will lose it.

Unfortunately, banks are not able to honor all payments at the same time which lead to bank run.

When it comes to bankruptcy, it is very hard for people to get all money back, but when they have mortgage they still have to pay it back to another organization. Obviously, they cannot be disappointed because of that. It would be quite ridiculous to get money "for free". The problem is that mostly the interest rate is higher than it was stated when they were taking the mortgage. Losing your assets but not your debts has serious economic consequences for the customer.

Major Parties Involved

Federal Deposit Insurance Corporation (FDIC)
The FDIC is a wonderful example of effective government regulation. It was created in 1933 during the Great Depression by Franklin D. Roosevelt. The president signed the Banking Act which led to creation of FDIC. This institution's primary purpose was to ensure that consumers who banked with an insured bank didn't lose their money when banks went bankrupt. FDIC covers only deposits actions and works only in USA.

Timeline of Events

18th century BC	History of banking started in Babylon.
4th century BC	New functions of banks were created in Rome and Greece.
12th – 13th century	Christians prohibition on usury- the Jews and the knights Templar started to take a big part in finance business.
17th century	-The Jews were replaced by Lombards. -Cheque was invented.
1668	The Bank of Sweden was founded.
1695	Bank of England began the permanent issue of banknotes.
1929	The Great Depression- worldwide economic depression.
1933	Federal Deposit Insurance Corporation is created.

1944	IMF and World Bank were funded.
1960s	ATM was invented.
21st century	Traditional banking replaced by internet banking.
2009	Worldwide financial crisis.

Previous Attempts to solve the issue

During the Great Depression, people were scared about their money in banks. They all wanted their money back which is known as a *bank run*. Of course, banks were not able to return their money which led to the creation of **Federal Deposit Insurance Corporation (FDIC)** which insures accounts against bank failure.

Later on, after the financial crisis of 2009, President Obama suggested "expanding the reach of a 1994 law that forbids banks from acquiring another bank if the deal would give it more than 10% of the nation's insured deposits. However they would not force existing financial firms to downsize." If the banks are not downsized, further regulations are needed. Mr. Obama suggested introducing regulations with the objective to prohibit banks from gambling with the bank's money. Mr. Obama said he wanted to force them to "choose between the protection of the government's safety net and the often-lucrative business of trading for their own accounts or owning hedge funds or private-equity funds".

Possible Solutions

In order to prevent banks from bankruptcy, all operations and investments that banks make, should be monitored. In this way, banks would not be likely to make risky or illegal investments. This would lower the risk of bank bankruptcy but it is unlikely for banks to agree for such actions as it would also lower their profits.

Additionally, sometimes banks are said that they are "too big to fail". This means that when they would go bankrupt it would have a horrible influence on economics so as to prevent it, governments need to bail out banks. Regulations are therefore needed to limit banks possibility of growing too large.

Another solution to help people who already lost their money because of a bankruptcy is to demand at least a substantial portion of loss from governments' banks.

FDIC plays an important roll in helping people during bankruptcies. That is why institutions like this should be supported. Likewise, they should be created all over the world to help not only people in the United States of America.

As it was stated earlier, the interest rate at the end of mortgage deal is higher than it should be when people are paying it back to another organization because of the bank bankruptcy. Of course this should be regulated in deal signed at the beginning of process of taking mortgage. It should state that when bankruptcy like this would occur, the interest rate will not get higher than it was stated at the beginning of the deal.

Last but not least, in order to protect people after a bank goes bankrupt, public function banks should be separated from business model banks.

In conclusion, there should be more safety nets created. *Safety net* is a collection of services provided by the state or other institutions which support the poorest and most vulnerable individuals from falling into poverty.

Appendix/Appendices

Definition of "Bank"
http://www.investopedia.com/terms/b/bank.asp

"A brief history of banking"
http://www.localhistories.org/banking.html

"History of banking"
http://www.historyworld.net/wrldhis/PlainTextHistories.asp?historyid=ac19

"History of banking"-*Wikipedia*
https://en.wikipedia.org/wiki/History_of_banking

"How banks work"
http://money.howstuffworks.com/personal-finance/banking/bank.htm

"How the FDIC works"
http://money.howstuffworks.com/personal-finance/banking/fdic.htm

"Should banks be allowed to go into bankruptcy"
http://www.math.chalmers.se/~rootzen/finrisk/Should%20banks%20be%20allowed%20to%20go%20into%20bankruptcy.pdf