The Business of Banking
What Every Policy Maker Needs to Know
About the American Bankers Association

The American Bankers Association is the voice of the nation’s $14 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $11 trillion in deposits and extend nearly $8 trillion in loans.

ABA believes that government policies should recognize the industry’s diversity. Laws and regulations should be tailored to correspond to a bank’s charter, business model, geography and risk profile. This policymaking approach avoids the negative economic consequences of burdensome, unsuitable and inefficient bank regulation.

Through a broad array of information, training, staff expertise and resources, ABA supports banks as they perform their critical role as drivers of America’s economic growth and job creation. This guide reviews the basics of banking and provides a foundation for understanding how banking policy decisions affect communities and constituents.”* 

*Data used in this book is current as of December, 2013 unless otherwise indicated.

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Introduction

Banks sit at the core of the basic credit cycle, which turns the economic wheel of the country. Understanding the business operations of banks and their involvement in this cycle is critical for policy makers.

The credit cycle is simple: customer deposits provide the funding to make loans. The loans allow customers of all kinds—businesses, individuals, governments, nonprofits and more—to grow and invest, creating more jobs, which leads to economic growth and prosperity. The wealth that is built through prosperity comes back into banks as deposits and the cycle continues.

The cycle of growth does not exist in a vacuum. Regulation shapes banks and can help or hinder the smooth function of the credit cycle. Nonbank competitors to banks and the shadow banking sector also impact the business of banking, the creation of jobs and economic growth.
Banks

Banks provide an essential financial function by linking depositors and borrowers. Banks, large and small, serve diverse customers, from individuals to businesses, governments and municipalities. This section reviews the basics of banking, bank innovation, and the role of banks in the economy.

Deposits

By depositing money in a bank, customers safeguard their savings and earn interest. They also benefit from a safe, easy way to pay bills and access their deposits. The Deposits section covers the basics of bank deposits, the payment system, wealth management like trusts and corporate services that banks offer to depositors.

Loans

Bank loans benefit individuals, businesses and governments, giving them access to the funding they need to achieve their goals. This section covers the types of lending that are unique to these customers and shows how banks work to increase lending.

Jobs

Thriving businesses—including banks—provide jobs in their communities and around the world. Financing large and small businesses is critical to a growing economy. This section reviews banks’ role in the mechanism of job creation.

Prosperity

Consumer purchases and business investments lead to economic prosperity. This section closes the cycle and shows how prosperity leads back to deposits and the community.

Regulation

Banks operate in a highly regulated environment. This section describes that environment and reviews the many agencies and entities that influence banking activities. It also discusses the implications that policy changes—such as new laws or regulations—have on the cycle of growth that banks help to facilitate.

Nonbanks

Many organizations deliver bank-like services, but in a very different regulatory environment. This section discusses several bank-like competitors and reviews the regulatory differences that lead to unintended consequences for customers and the credit cycle.
Shape of the Banking Industry

6,800
Banks, of many sizes and types, add up to over this number.

97,700
Branches total over this.

88%
Most banks are classified as a small business using guidelines set by the Small Business Administration.

50 Years
Two in three banks have been in business this amount of time. Two in five banks have been in business for over a century.

$14.7 trillion
The amount that banks hold in assets.
Banks

A bank is a place that safeguards customers’ deposits and uses their deposits to lend. Banks offer a myriad of additional services that improve the lives of customers and help businesses thrive. The fundamental functions that banks perform impact the economies of their communities and the country.
What Are Banks?

There are more than 6,800 banks in the United States with more than 97,000 branches in communities across the nation. Banks play an important role in their communities, providing a safe place to keep money, funding for business growth and community projects and time and money for local charitable projects. Banks invest in their communities because they know the financial health of the community depends on it. A bank cannot thrive unless the people it serves thrive also.

Banks’ investment in their communities is an important part of a the relationship they maintain with one another, a relationship that may last for generations. In fact, there are 2,681 banks—40 percent of the banking industry—that have been in business for more than a century; 67 percent (4,582) of banks have been in business for more than half a century.

Most banks are small. The Small Business Administration defines a small business as one that has fewer than 500 employees for most industries. By this measure, more than 6,000 banks—88 percent of the industry—are small businesses. The median sized bank employs just 41 people and has $204 million in assets. Over 2,800 banks—40 percent of the banking industry—have fewer than 30 employees.

Although most banks are small, the industry is big—$14.7 trillion in assets—and employs over two million people. The 50 largest banks have more than 75% of the industry’s total assets, which enables them to serve the unique needs of large, often global businesses, in addition to local customers.

Deposits and Loans for All Kinds of Customers

In its simplest form, traditional banking involves accepting money from depositors and loaning it to borrowers. Banks serve a variety of customers—individual consumers and businesses of all sizes, as well as federal, state and local governments. Putting money in a bank enables these customers to safeguard their savings while earning interest for the use of their money. Customers also benefit by having a safe, easy way to pay bills by check or, increasingly, through various forms of online payments.

Customers also benefit from bank loans which significantly increase customers’ buying power and improve their quality of life. For example, without loans many Americans would not be able to buy a house or a car. Loans are also very important for businesses that use them to expand, purchase new inventory, buy new equipment and modernize, often creating new jobs in the process.

Banks also assist local, state and federal governments. It would be nearly impossible to find any federal, state or local governing body, such as a local park district, library or public school that does not use banking services.
Bank Innovations Bring Convenience

An important strength of the banking industry is its ability to adapt to the changing needs of its customers. Banks are committed to using new technologies to deliver banking services. Innovations—from ATMs and debit cards to online banking, electronic bill pay and mobile banking—have made money management more convenient and have given customers 24/7 access to their accounts.

**New Policy + New Technology = Better Customer Service**

For example, as a result of the attacks of September 11, planes across the country were grounded causing delays in processing paper checks that needed to be delivered throughout the 12 Federal Reserve Districts. Subsequently, Congress passed a law that would allow digital images of checks to be treated as if they were the original paper check. Banks could scan paper checks and send them electronically for clearing instead of having to physically deliver them. Today, virtually all paper checks are cleared faster electronically, and check clearing is not vulnerable to disruptions in air travel.

While check processing was migrating to an all-digital format, there was a huge leap forward in consumer adoption of advanced mobile phone technology. Newer smartphones offered new services such as Internet access and cameras. Banks made good use of the new digital check processing law by combining it with the convenience of consumer smartphones and created a new way to make check deposits. As with many bank innovations, consumers directly benefited. Instead of going to a bank branch or ATM, customers now can use a smartphone bank “app” to take a picture of a check and make a deposit anywhere, anytime. Banks, at the forefront of innovation, leveraged emerging technology to better serve customers.

“Community banks are well positioned to go beyond the standardized credit models…and to consider a range of factors when making credit decisions.”

Ben Bernanke, Former Federal Reserve Chairman
Bank Income and Expenses

Banks earn interest income from making loans and from other assets. Banks also earn income from many traditional banking services for which they charge a fee, like serving as the trustee for trusts or providing recordkeeping for retirement plans. Other non-interest income comes from income sources such as rental of safe deposit boxes, sale of checks and ATM income and fees.

**DID YOU KNOW?**

Banks supported their 2.1 million employees with more than $188 billion in salaries during 2013.

**DID YOU KNOW?**

Banks paid over half a trillion dollars in taxes between 2003 and 2013.

More than half of all bank expenses are direct payments to important constituents:

- Employees in the form of salaries
- Customers in the form of interest on deposits
- Local, state and federal communities in the form of taxes that support public goods and services

Other non-interest expense is 33 percent of bank expenses, including ATM and interchange, legal, marketing, and FDIC deposit insurance expenses.
Bank Taxes

The banking industry paid $69.4 billion in income taxes last year, excluding property taxes and other local fees paid by banks. For example, in Texas alone banks paid $1.5 billion in federal, state, local and foreign income taxes.

Banks in the Economy

Banks Contribute to Economic Well-Being

By making loans and providing a safe place to deposit money, banks help local communities grow and prosper. Small business and agricultural loans are examples of how banks directly contribute to the economic vitality of their communities by enabling businesses to expand and hire workers. Banks also create jobs for their communities and generate returns for their stockholders, thus contributing to the economic growth of local communities and the nation as a whole.

Trillions of dollars flow through the banking system each day. Each year, banks process more than 40 billion paper and electronic checks, valued at nearly $69 trillion in 2012. Online and mobile transactions, which are increasingly important to our economy, would not exist without the electronic payments infrastructure built and paid for by banks. Customers, participating in daily credit, debit and other transactions put their trust and confidence in a secure system.

Through the payments system, banks facilitate the flow of money throughout the United States and around the world. Without the payments system, national and global economies could not function.

Banks Benefit Local Communities

Banks do much more than make loans and safeguard customers’ savings. They also are major contributors to charitable causes:

- Financial services firms are major contributors to charitable causes
  In 2012, 16 of the top 50 corporate foundations based on total giving were financial services firms, according to data from the Foundation Center. Overall, the 16 institutions contributed over one-third of the $2.3 billion of corporate giving by the top 50 corporate foundations.

- Banks contribute more to community development
  In 2010, financial services firms devoted the largest share of their giving (compared to other sectors) to community and economic development.

- Most financial services firms have a formal employee volunteer program
  Bankers commit 58,600 volunteer hours annually to ABA financial education programs alone.

“One element that has kept the traditional model alive for so long is that community banks know their customers—and likewise, their customers know them—which I believe fosters greater customer loyalty.”

Ben Bernanke, Former Federal Reserve Chairman

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Did You Know?

16 of the top 50 corporate charities are banking organizations.

Video: Bankers in the Community
There Are 6,000+ Community Banks

- Community Banks: 6,148
- Large Community, Regional & Money Center Banks: 565

Bank Asset Class

- <$1 T
- $1 T
- $10
- $100 B
- >$1 T

Banks Have Record Capital Levels

- Total Equity Capital, $ B:
  - $0
  - $400
  - $800
  - $1,200
  - $1,600

Industry Is Consolidating

- Number of Institutions:
  - 1985: 19,000
  - 1993: 14,000
  - 2001: 9,000
  - 2013: 6,000

Bank Business Focus

- Agricultural Lending: 22.5%
- Commercial Lending: 49.6%
- Consumer Lending: 18.2%
- Credit Card: 0.8%
- International: 0.2%
- Mortgage Lending: 8.6%

Banking in Pictures

Most banks are small, serving the unique needs of their local communities. The median sized bank is $204 million and employs 41 people.

Bank capital levels are at an all-time high, providing a strong foundation for supporting loans and an important buffer for any economic challenges that may arise.

In 1991 there were over 14,500 banks; today there are fewer than 6,800. The challenging operating environment among other factors has led to consolidation.

Banks specialize their businesses to serve their customers’ needs.
Banks Employ 2.1 Million People

Financial Services Added $21 Billion to Net U.S. Exports

Banks are a primary employer within their local communities.

Interest income, the largest portion of a bank’s income, is used to pay for expenses like safekeeping of deposits and compliance costs. Page 10 explains the next largest portion.

Banks face a challenge of steadily rising operating expenses as they work to comply with increasing regulations.

Financial services are a key U.S. export, helping to offset our more than $42 billion trade deficit.
Deposits Add Up

$11 trillion
Customers trust banks with this amount of deposits.

$9.7 billion
Banks paid this amount in FDIC premiums to protect customers’ deposits in 2013.

67%
This portion of households has both checking and savings accounts.

$2 trillion
Bank deposits have grown by this amount since 2008.

68%
Domestic deposits fund this portion of bank loans and other assets.
Deposits

Individuals, businesses, nonprofits, municipalities, states and federal government entities all make deposits at banks. Customers benefit by having their funds safe and readily accessible. They also receive access to a convenient, easy way to pay bills by check or, increasingly, through various forms of online payments. Additional bank services help customers build wealth.
Banks and depositors are partners when it comes to savings. Banks pay depositors interest on savings at varying rates, depending on the type of product. Products with longer time frames, like multiyear certificates of deposit, usually offer higher rates of interest than accounts with shorter terms or that offer on-demand access, like basic savings or checking accounts.

Accounts that offer full access—such as checking or other transaction accounts—allow customers to make unlimited transactions. Since it is harder for banks to commit these funds to loans, little or no interest is paid to account holders. However, the accounts are often combined with free services, such as free checking (if the balance is maintained above a certain level). Deposit account types include:

- Checking accounts
- Savings accounts
- Certificates of deposit (CDs)
- Money market deposit accounts (MMDAs)

“There are many positives to establishing a relationship with an insured financial institution. Access to an account at a federally insured institution provides households with the opportunity to conduct basic financial transactions, build wealth, save for emergency and long-term security needs, and access credit on fair and affordable terms...”

Martin Gruenberg, FDIC Chairman

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**SAFEGUARDING SAVINGS**

**CUSTOMER CONFIDENCE**

**Banks Pay to Insure Depositors**

The Federal Deposit Insurance Corporation (FDIC) insures deposits up to $250,000 per depositor, per federally insured institution. Customers highly value the security of knowing their funds are protected.

All FDIC member banks pay the premiums that fund the Deposit Insurance Fund. In fact, banks are solely responsible for all of the FDIC’s expenses, from paper clips and office supplies for its day-to-day operations, to the losses incurred when a bank fails. No taxpayer funds are used.
Business and Government Transaction Accounts

Businesses, municipalities and state and federal government entities must have a reliable mechanism to manage their funds. Banks, through the payments system, are vital partners with businesses and governments. Banks provide a wide array of services, helping them receive payments from customers, facilitate payments to suppliers and manage the receipt of cash. Special services and accounts that banks offer businesses and governments to manage cash include:

- Lockboxes
- Sweep accounts
- Disbursement accounts
- Bank drafts (bills of exchange)
- Remote deposit capture
- Business credit and debit cards

BACKGROUND

Banks Work Closely with Municipalities

Banks have long worked closely with their local municipal bodies—city governments, schools, libraries, hospitals and numerous boards and commissions. These municipalities need all of the banking services that individuals and businesses need: deposit accounts, cash management, loans, pension advisory services and much more. In addition, many bank employees serve their communities through appointments to or volunteering for local boards and commissions.

One unintended outcome of the Dodd-Frank Act may be to limit the services banks provide to municipalities. Dodd-Frank established a regulatory scheme for unregulated entities providing “advice” to municipalities with regard to “municipal financial products” related to securities. A rule proposed by the Securities and Exchange Commission (SEC) would reach all “funds held by or on behalf of a municipal entity,” including funds in deposit or cash management accounts or pension funds contributed by municipal employees.

Because the SEC didn’t define “advice,” this could mean that a teller that helps a local government employee open a government deposit account would have to be registered as a municipal advisor and be regulated by the SEC. The SEC’s proposal also would require bank employees that volunteer for local government boards and commissions to register. Some banks may choose not to take on the new costs and liabilities that come with receiving the deposits of local communities or making loans to them.

CUSTOMER CONFIDENCE

Reliable Access to Accounts

Banks consistently deliver funds to customers when they request them. Access is assumed—even in emergency situations. For example, after Hurricane Katrina, many banks in flooded areas were open for business within 24 hours of the storm, despite damaged or destroyed branches. More recently, in advance of Superstorm Sandy, many banks deployed temporary ATMs and opened for business soon after the storm, announcing waived fees for customers affected by flooding and power outages.
Convenient Access to Payments and Funds

Bank customers expect and demand convenient fund access 24 hours a day and seven days a week around the world. Banks have responded with many ways to make and receive payments. Paper checks are familiar, but electronic payment methods, as shown below, are more common. Here are some examples:

The Automated Clearing House (ACH) system is used to execute bill pay and direct deposit transactions, as well as business-to-business payments. The ACH system processes transactions in large batches daily through central clearinghouses.

Wire transfers are accomplished through a direct connection between two banks. The funds are transferred immediately and settlement is final.

Payment cards, which access both deposits (debit cards) and loans (credit cards), provide everyday convenience for making purchases that is enjoyed by individuals 24/7 around the world.

Mobile payments, or digital wallets, take advantage of advances in smartphone technology allowing individuals to use their phone to initiate payments instead of plastic cards. Transactions are often funded by a debit, credit or prepaid card linked to the smartphone’s payment application. Person-to-person (P2P) transfers of funds via mobile devices is another payment mechanism that customers are exploring and banks are offering.

DID YOU KNOW?

Ancient cultures used instruments similar to checks.

DID YOU KNOW?

Payment cards are responsible for more than $3.5 trillion in 2012 transactions.

DID YOU KNOW?

The payment processing system handled about 3,900 transactions every second in 2012.

![Consumer Payments Chart](chart.png)

Source: The Nilson Report 2011
Protecting Customer Accounts

Regardless of the method used by bank customers to access their funds, banks expend considerable resources protecting customer accounts from unauthorized access and fraud. The three main objectives in protecting customer account information are to: 1) ensure the security and confidentiality of customer information, 2) to protect against any anticipated threats or hazards to the security or integrity of such information and 3) protect against unauthorized access to or use of customer information that could result in harm or inconvenience to any customer.

To help protect bank customers from fraud, banks take a layered approach, using security controls consistent with the level of risk of the transaction or to the bank customer’s account. Effective controls may include the following:

- Determining if requests to access an account via any channel are from actual customers and being made by those customers, not others
- Detecting fraud and monitoring transactions to determine if account activity is typical for the bank customer based on history and behavior
- Verifying transactions, particularly if conducted online, such as through a text to a mobile device
- Using questions that verify customers; to which only they know the answer, particularly when customers are not using their typical device

Banks Pay for the Risk of Fraud

Banks cover the significant risks and costs associated with providing electronic payments. With the majority of bank customers accessing their accounts via the Internet—often through a mobile device—customers have become accustomed to having their funds available 24/7. Banks protect this constant availability with an intricate set of security measures, which include physical controls, such as locked perimeters and enclosures, and PIN and password secured locks. Security measures also include network controls, such as firewalls to prevent unauthorized or covert use of the network and intrusion detection systems to monitor network inquiries and activity. Interchange fees help to pay for these risks, costs, conveniences, security measures and physical controls.

... And Protect National Security

Banks have first-hand experience with terrorist attacks and cyber attacks by organized criminals and protest groups. Banks have also been in the direct line of major natural disasters. Banks have robust security programs in place to protect their systems, but they also rely upon information sharing with federal agencies to help safeguard their critical systems. It is only through an active public-private partnership that our industry and government can ensure that all resources are working in concert to protect and defend our nation’s financial systems from cyber and other attacks. Legislation designed to enhance this partnership could be helpful, but great care must taken to avoid excessive regulatory requirements that could actually undermine public-private partnership efforts.
Saving for the long term involves some amount of risk. Savers often turn to the asset management and advisory services offered by bank trust departments and bank affiliates or subsidiaries, which help customers access products that meet the customers’ savings needs, time horizon and risk preference.

**Retirement Accounts**

Perhaps the most familiar wealth-building activity for individuals is saving for retirement. Individuals can open tax-advantaged accounts called individual retirement accounts (IRAs) in the bank in the form of a CD or other traditional, FDIC-insured products.

Employers—both business and government—have more complex needs and work with banks to set up plans for the benefit of their employees. Many employers establish defined benefit plans (e.g., traditional pension plans) and/or defined contribution plans (e.g., 401(k) plans). Banks with fiduciary powers—legal duties that require them to act in the best interests of their client—serve as advisors to these plans and help to prudently manage the investments on behalf of the employers. Banks also act as service providers to these plans in other nonfiduciary capacities such as record keeper or custodian.

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**DID YOU KNOW?**

Customers trust banks and their affiliates with retirement accounts valued at about $10.7 trillion.

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**Where Consumers Keep Their Savings**

- Corporate Equities: 21%
- Pension Fund Reserves: 29%
- Noncorporate Equities: 13%
- Deposits: 14%
- Mutual Funds: 10%
- Bonds: 8%
- Life Insurance: 2%
- Other: 3%

Source: Federal Reserve Board
Bank Investment Management Accounts

Many banks provide investment management services for the portfolios or particular assets of individuals, families and institutional investors such as insurance companies, business entities, governmental bodies and endowments. Customers have many options. They can leave investment decisions up to the professionals in the bank or just ask for advice and do it themselves. Within these investment management accounts, banks may manage and provide advice on various types of assets for their customers, including the following:

- Stocks and bonds
- Financial derivatives
- Hedge funds
- Real estate
- Mineral interests
- Art

In addition to investment management accounts, banks can provide financial planning services to clients. This advice may cover savings, retirement, taxes, insurance and estate planning, among other things.

Brokerage and Investment Adviser Accounts

Some banks have broker-dealer affiliates (see below for more information on affiliates) that offer investment accounts to the public. In these accounts, individuals and businesses can direct the broker-dealer to purchase and sell securities on a commission. If the broker-dealer offers advice or has investment discretion over the account, it must be registered with the Securities and Exchange Commission as an investment adviser. Investment advisers can provide investment advice for a fee, as well as manage a portfolio of securities on behalf of the customer. Investment advisers can also provide financial planning services to help clients develop strategies or financial plans to meet their particular goals.

BACKGROUND

Bank Structure: How Do Affiliates Work?

Bank affiliates are sister companies under a bank or savings and loan holding company. A holding company is any company that owns one or more banks. Because the holding company structure makes it easier to raise capital, about 75 percent of banks are organized this way.

Holding companies can own more than just banks. They can own mortgage companies, broker-dealers and more, all referred to as affiliates. This structure is a benefit to bank customers who want more financial products. Customers can work with a familiar company and people and access more than just deposit products. Holding companies are supervised by the Federal Reserve to ensure the bank’s safety is not jeopardized by affiliate activities. The affiliates, as appropriate, are also regulated. See page 45 for the chapter on bank regulation.
Customers have long relied upon banks for many kinds of trusts, including revocable, irrevocable, family and charitable trusts. Under a trust, the trustee (bank) takes legal title to the trust property to manage it for the benefit of the trust beneficiaries.

Trusts can be very specific and establish careful instructions for any party to the trust and typically outline both the responsibilities of the trustee and the benefits of the recipient, the beneficiary.

This makes a trust a very flexible tool for all kinds of users, such as:

**Individuals:** Individuals often use trusts in estate planning to set up funding for loved ones.

**Charitable organizations:** Banks often serve as a trustee of charitable trusts that make financial contributions to one or more charitable entities. In addition, some banks serve as a trustee for private foundations that make grants.

**Employee Benefit Plans:** Many employers offer their employees retirement benefit plans such as defined benefit and defined contribution plans. These plans are most often established as a trust. Bank trust departments can act as trustee to these retirement plan trusts and assume the responsibility for holding, investing and keeping records on the assets in the plan, as well as making distributions and accepting contributions as needed.

How Bank Trust Departments Keep Assets Safe

**Banks Are Fiduciaries**

The trust departments of banks adhere to the highest fiduciary standards under state statutory and common law, protecting both the interests of beneficiaries and the assets placed in the care of the trust department. This fiduciary duty requires them to be loyal, serving only the interests of the beneficiaries. It also requires them to be impartial, even when they have two beneficiaries with potentially competing interests. Bank trust departments are regularly examined in accordance with these and many other requirements.

**Banks Separate Trust Assets**

The noncash assets (e.g., stocks, bonds, real estate, etc.) of a trust, retirement, investment or custody account are completely segregated from the bank’s assets. If something were to happen to the bank, creditors of the bank do not have access to these funds. Account ownership remains with the individuals or entities for whose benefit the bank is acting as fiduciary or custodian and can be transferred to another fiduciary or custodian at any time.
Banks Help Customers Meet Specific Needs with Trusts

Individual customers turn to their banks to help them meet specific financial needs, such as:

- Passing along a family farm or business to the next generation
- Providing for the children from a previous marriage
- Ensuring that a disabled adult or child receives the benefit of desired property or other assets
- Allowing a surviving spouse to receive income from inherited assets and then passing the income or assets onto a designated charity when the spouse passes
Banks Are the Primary Source of Credit

- **$250 billion**: Banks have added this amount of business loans in the last two years.
- **25 million**: Banks financed more than this number of small business loans in 2013.
- **$425 billion**: Banks lend this amount to state and local governments.
- **$1.8 trillion**: Banks hold this amount in mortgage loans.
Loans

Credit is the lifeblood of our economy and banks are its primary provider. Banks and their customers work together when it comes to saving and lending. Banks pay interest to attract customer savings deposits. In turn, banks use a portion of those deposits and other money to fund a range of credit products for consumers, businesses of all sizes, governments and municipalities.
Credit enables consumers to accomplish goals, such as purchasing furniture, cars and homes. Credit enables consumers to borrow the money they need to make a purchase now and pay it off over time.

**Residential Mortgage Lending Builds Relationships**

The biggest dream for many consumers is to purchase a home. This dream can become a reality through a mortgage, which stretches the payment out over many years. It is not surprising that mortgage loans account for 70 percent of all household debt.

The mechanics of residential mortgage lending are simple. A bank provides its customer with most of the funds to purchase a home and in exchange, the customer promises to repay the bank and provides the home as collateral. Since the home is collateral, should the homebuyer someday be unable to repay the loan, the bank can take and sell off the property to recoup a portion of its losses. That collateral makes the loan less risky and keeps interest rates as low as possible. The bank and customer work together to find a payment term—typically from 15 to 30 years.

**DID YOU KNOW?**

Banks have about $1.8 trillion in mortgages on their books.

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"You’re thinking of this place all wrong. As if I had the money back in a safe. The money’s not here. Your money’s in Joe’s house...right next to yours. And in the Kennedy house, and Mrs. Macklin’s house, and a hundred others.”

George Bailey,  
*It’s a Wonderful Life*

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**CUSTOMER CONFIDENCE**

**Banks and Customers Work Together to Find the Right Loan**

Banks work with their customers to find the type of loan that achieves their goals. Banks help customers to understand the loan terms and how to pay it off. This partnership allows customers to develop long-term relationships with their banks, and such long-term relationships are a key to a bank’s success. Because it is central to banks to treat customers fairly, the banking industry fully supports effective consumer protection.

Banks have a proud history of prudent lending to creditworthy households, accomplished through these sound underwriting practices. Leading up to the financial crisis, many nonbank competitors loosened underwriting standards and contributed to the housing boom—and bust. Most traditional banks stayed true to conventional standards but will still be required to comply with the increased regulatory requirements that have followed the housing meltdown. These new rules for mortgage lending programs and products limit banks’ ability to address consumer need. New regulations mean less flexibility when underwriting mortgages and higher compliance costs, too—limiting banks’ ability to lend. As a result, banks find it harder to meet the increased demand from qualified borrowers for mortgages, frustrating borrowers, banks and economic growth.
Credit Cards Benefit Consumers, Businesses

Credit cards have become an everyday tool for customers—and businesses—to make purchases and manage their finances. In fact, according to the Federal Reserve, nearly 78 percent of American families now have at least one bank-issued credit card. It is no wonder, considering the benefits cards provide:

- Credit card customers receive the benefit of a secure and convenient purchasing experience, providing them with seamless access to funds at any time day or night, almost anywhere in the world. The loans can be interest free (if paid back within 30 days) or with interest over time, all at the customer’s choice.

- Merchants who accept cards allow customers to speed through the checkout line, receive significant increases in sales volume, reduce fraud risk, and guarantee payment, creating a more positive experience for customers.

Because credit cards are so simple and convenient to use today, it is easy to take for granted the decades of investment and innovation that were required to make this so. Credit cards started in the 1950s as charge cards that had to be paid off in full each month. Soon, companies began to allow customers to pay their balance over time and at any merchant. These transactions were processed on a manual carbon imprint machine.

Today’s credit card business involves a vast electronic infrastructure that connects consumers, merchants, banks, investors, card networks and transaction processing equipment. This system has evolved over decades at a significant cost and is the result of considerable effort and innovation. Remarkably, despite the costs and the risks involved, card issuers continue making unsecured, open-ended loans available to consumers who can continually access them over a long period of time.

Learn more about interchange fees at aba.com/KeyIssues.
Small Business Lending Spurs the Economy

The presence of banks in communities throughout our nation is critical to meeting the unique needs of small businesses. By lending to small businesses, banks help them to expand, create jobs and spur economic growth. Bankers know that the future of their communities and regions depends on their support for small business. It’s a partnership that works for the business owner, the community and the bank.

Credit Cards for Small Businesses

Traditional business loans are only one way that small businesses access credit. Many businesses get started—and continue to operate—through the use of credit cards. Credit cards provide unique benefits for business owners, according to the Small Business and Entrepreneurship Council. These benefits include:

- Facilitating market expansion
- Guaranteeing payments
- Enabling businesses to weather economic difficulties
- Enhancing efficiency
- Eliminating the cost of setting up and maintaining in-house credit and billing systems
- Reducing or eliminating employee theft

A recent study shows that small business use of credit cards is a strong contributor to growth, enabling businesses to hire and stimulate the economy.

Small Business Administration Loans

One way that bankers partner with small businesses is by offering loans through the Small Business Administration (SBA) program. SBA loans are designed to make credit available to small businesses that cannot get credit on reasonable terms elsewhere. These loans can be used to finance the start up, operations or expansion of a business. The SBA guarantees loans made to qualified small businesses, transferring some of the risk from bank lenders to the SBA. SBA-guaranteed loans through banks have helped thousands of small businesses become established, grow and thereby create jobs and economic development.
Banks of All Sizes Serve Businesses of All Sizes

Different sizes of banks serve the unique financial needs of diverse businesses. Smaller, local community banks get to know their business customers personally, and the relationships sometimes span generations. Larger banks provide the financing and specialized services that large businesses and multinational corporations demand.

An example of a need that only a large bank could fill is intraday lines of credit. Large multinational businesses need large amounts of cash on a short-term basis for business operations. Large banks provide these companies with billions of dollars of “working capital” credit, so the funds are there when the business needs them for payroll and other purposes. This allows the business to use its cash to create jobs and expand operations rather than holding it idle in an account for when it might be needed.

Smaller banks supply the credit needed by smaller businesses, many of which provide critical support for large companies. Banks of all sizes provide loans to the employees who work in small and large businesses alike, and to the retail stores where those employees shop.

“You need size, you need scale, because you need a solid funding base to commit large amounts of capital for clients.”

Daniel Pinto, JPMorgan Investment and Corporate Bank Co-Chief Executive, told Financial Times.
Banks help state and local governments finance their operational needs with loans. For example, banks might finance the government purchase of additional police cars, fire engines or equipment to build roads. Such loans are often similar to business loans. One unique type of loan that a bank offers municipalities is a tax anticipation loan, where municipalities borrow against revenues they expect to receive in the near future. This helps governments to bridge the temporary gap between expenditures and revenue.

Letters of Credit Allow Large Purchases

Banks also serve governments by offering letters of credit, just as banks do for their commercial customers. A letter of credit is a guarantee issued to a seller that the purchaser will pay for the good or service purchased. This service allows governments to pay for their purchases at some point in the future, better managing cash flows.

Banks Support the Municipal Bond Market

Municipal bonds serve as a funding source for municipal infrastructure projects such as schools, courthouses, water treatment plants and roads. Banking institutions support this market both as major investors and by standing ready to buy and sell municipal bonds.
Banks and Government Work Together

Banks and governments work together to promote important social and economic objectives through government-sponsored loan programs. For example, state or county governments may work with banks to finance the construction of a hospital. Loan subsidies and guarantees enable banks to make loans to those who otherwise could not afford them.

FUNDING FOR LOANS

The main funding source for banks is deposits—customer deposits make up 68 percent of bank funding. Banks also access other resources so that they can make more loans. For starters, many banks are organized as subsidiaries of bank holding companies. Investments from those holding companies provide 15 percent of bank funding.

Banks go to the capital markets for about 7 percent of their funding by issuing bonds and other credit market instruments. Bonds are not insured by the FDIC, so they pay a higher rate of interest than an insured deposit. This compensates investors for the additional risk. Banks issue debt in different maturities to match the timeframes of the types of loans they make.

Banks also routinely lend to each other, which makes up 2 percent of funding. The remaining sources of funds are spread out over a number of categories; these sources can also be used to fund loans.
Federal Home Loan Bank Advances Supplement Funding

Another major source of funding for bank lending is to become a member of the Federal Home Loan Bank (FHLB) System. The Federal Home Loan Banks are cooperatives that were created by Congress as a response to the Great Depression of the 1930s. The FHLBs help to ensure that community banks have funds to lend to customers in all market conditions. The FHLBs have been particularly beneficial for portfolio mortgage lenders—those that hold rather than sell loans in the secondary market (e.g., to Fannie Mae and Freddie Mac).

Banks become members of one of the FHLBs by buying stock in it. Banks are then eligible to borrow funds (called advances) from the FHLB, in return for pledging specific assets on each member bank’s books. These assets generally consist of home mortgage loans, although some other assets such as farm and small business loans are also allowed. Member banks use these advances to extend new home loans or other consumer loans to customers.

The FHLB system has worked very well over the past 80 years, particularly during the early stages of the recent financial crisis. Interbank funding at that time was challenged, but FHLBs continued to provide lendable funds to their member banks, even as other credit markets around the world froze.
Banks Expand Lending Through Securitization

Another way that a bank can expand lending is to sell its loans. When the bank receives payment for the loans, it can increase lending to new borrowers.

The buyer of the loans pools loans with similar attributes together, creating a security. For example, similar mortgage loans might be pooled together. Securities are then sold to investors, with the pool of loans as collateral. The interest and principal payments collected from the loans over time pay back the investors. This process is known as securitization.

Securitization has been used extensively to securitize home mortgages, called mortgage-backed securities (MBS) and also for other types of loans, including automobile loans, credit card accounts, and home equity loans. When the secondary markets and securitization work well, banks can lend more money. Moreover, these loans are typically at lower interest rates, because the risk is spread across the many investors of the securities. Banks in this way rely on the secondary market to ensure borrowers have adequate access to the money they need.

BACKGROUND

Government-Sponsored Enterprises and Mortgage Securitization

Two government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, were put in place by Congress to support the housing and mortgage markets and to expand opportunities for homeownership and affordable rental housing. Fannie Mae was chartered during the Great Depression and was tasked with providing local banks with federal money for financing home mortgages by providing a guarantee on the securitization, allowing banks to originate more mortgages. After Fannie Mae was made into a private institution in 1968, Freddie Mac was chartered to carry out a similar purpose. Together, they currently purchase or guarantee about 65 percent of new mortgage originations in 2011. The market dominance of the GSEs has remained particularly high in recent years as a result of the financial crisis and the reluctance of the private market to reenter mortgage finance until the market shows greater stability.

Although both of these evolved into private corporations without an explicit guarantee by the federal government, many believed that they would be supported in the event of a major downturn, which is exactly what happened when both Fannie Mae and Freddie Mac were put into conservatorship in 2008 to avoid insolvency. Under the conservatorship of the Federal Housing Finance Agency and with financial support provided by the U.S. Treasury, Fannie Mae and Freddie Mac have been able to borrow in international markets at low rates. Following the financial crisis, the private securitization market for mortgages has been almost nonexistent. The two GSEs, funded by Treasury, were able to continue securitizing residential mortgages. FHFA has the authority to manage the GSEs while they are in conservatorship. Congressional action is necessary for the GSEs to exit conservatorship and determine the long-term structure of the housing finance system, which nearly all agree must rely more heavily on private capital.
Banks Facilitate Job Creation

2.1 million
People employed by banks in the U.S.

60%–80%
Small businesses generated this percentage of net new jobs over the last decade.

97,700
Banks reach every community with this number of offices and branches.
Jobs

Banks play a key role in the cycle of business development and job creation in every community in the country.

Businesses looking to expand, by hiring employees or by investing in new plants or equipment, need funding. Banks help small businesses develop realistic business and expansion plans that can be supported by prudent borrowing. Banks, businesses themselves, also create jobs as they grow and expand to meet the needs of customers.
Companies use business loans for multiple purposes including investments to help their firms grow. As businesses expand, they buy new equipment, build new plants and may purchase real estate.

The process of investing in the expansion of businesses and hiring leads to economic development. A company investing in new capital equipment—such as factory machines, trucks or equipment—creates orders for equipment suppliers. The supplier hires additional workers to meet the increased orders and may borrow to finance this growth. A number of other jobs are created farther down the chain, as well, to transport the new equipment and provide raw materials. This process feeds back to expansion of the initial company’s business, requiring it to hire more employees.

For example, if a small automobile repair business gets an influx of new business, there is an immediate direct gain in local employment. The business owner may ask existing employees to work more hours or hire new workers. The business owner also has an increased need for supplies such as tires, parts and tools. As the auto repair suppliers work to meet the increased demand for their products, they, too, hire more employees. All of these new employees’ households have more discretionary money to spend on groceries, entertainment and other goods and services. In turn, those businesses in the region may also hire more workers.

DID YOU KNOW?
Banks financed more than 21 million small business loans in 2013.

DID YOU KNOW?
Expanding their business was the second most important reason small businesses sought financing (38 percent). A close fourth was to purchase machinery and equipment (30 percent).

What Banks Do to Impact Hiring Through Business Loans

Banks partner with businesses to grow and expand by providing loans and other services. These businesses, and their employees, can be confident that banks lend in any economic climate. A bank can only be successful if its customers are successful.

Banks average increase in business loans outstanding was about $36 billion for each of the past 10 quarters while nonfarm employers added 550,000 jobs on average. Small businesses are central to creating jobs, and those less than two years old have accounted for about a fourth of job creation in the last two decades. Banks have increased small business and farm loans by over one million during the last two and a half years.

Banks provide innovative credit programs to encourage responsible small business job creation. For example, a “loan-to-hire” bank lending program reduced the interest rate on existing small business loans with a hiring commitment. Banks, as Community Development Financial Institutions and Small Business Administration partners, work with the government to reach more businesses with start-up and other loans. Over $4.5 million has been lent in one start-up loan program this year.
Banks Serve Other Businesses and Stimulate the Economy

More Jobs
Faster Growth
Stronger Economy
Business Credit Card Use Increases Available Jobs

Small and start-up businesses employ many people and use business credit cards for short-term financing. Having access to this type of financing frees up other funds that can be used to hire additional workers. As access to this type of credit or other types tightens, small businesses are likely to freeze hiring or even lay off employees.

A recent study found that a 1 percent increase in national small business credit card use is associated with about 17,000 small business jobs. Firm owners who did not have credit cards had the lowest employment growth rates over three years.

According to the National Federation of Independent Businesses, small businesses play a major role in the American economy by representing 99 percent of all employer firms, employing about half of private-sector employees and generating 60 to 80 percent of net new jobs annually over the last decade.

DID YOU KNOW?

For every job directly created as a result of increased small business credit card use an additional 1.7 jobs are generated elsewhere in the economy.
Banks as Working Businesses Create Jobs

Banks, together, are large employers. In fact, banks directly employ over two million people nationally and provide many jobs in each state.

The physical presence of banks in small towns and large cities everywhere—with more than 97,700 bank offices and more than 440,000 ATMs—gives banks a big stake in the economic growth and vitality of nearly every community.

As the economy grows, so do banks. As banks grow, so does their workforce and their need for materials to support their business. The supplies and services banks purchase from other businesses indirectly create additional jobs.

Banks Have 2.1 Million Employees In Offices Across the Nation

DID YOU KNOW?

Banks have more locations in the United States than movie theaters or shopping malls.
Banks Promote Increased Prosperity

$1
Bank deposits of this amount are lent to create economic growth that leads to incomes many times this investment.

68%
Consumers accounted for this percent of national income as a portion of GDP in 2013.

$71 billion
Banks provided this amount in farm operating loans, critical to supporting our nation’s farms.

$114 billion
Farms provide over this amount of income to local communities each year.
Prosperity

Banks lend to consumers and businesses so that they can achieve their goals. In turn, the economy expands as personal income rises, new jobs are created and businesses have new incentives to expand. Higher income and greater revenue flow back into banks as deposits. This restarts the deposit–loan–jobs–prosperity cycle and demonstrates banks’ central role in creating prosperity. It also makes clear that banks’ success depends on that of their customers and communities.

42 MULTIPLIED PROSPERITY IN THE ECONOMIC CYCLE

43 ADDITIONAL BANK CONTRIBUTIONS TO PROSPERITY
In our modern, competitive, global system, businesses need to act quickly to hire workers and buy inventory, equipment and new facilities when the investment opportunity for further expansion arises. This cannot be done with just cash on hand or reaching out to new investors for additional capital.

Rather, bank loans quickly provide key funding to assure U.S. companies have a competitive advantage. The U.S. economy is one of the strongest—if not the strongest—economy in the world because of the advanced banking and financial system. Bank financing keeps our economy moving quickly and smoothly.

The process of investing in the expansion of businesses and hiring leads to economic development throughout the local economy. Three things happen when banks provide credit to businesses:

1. Businesses grow, spending more money on employment and increasing revenues.
2. Businesses purchase more from suppliers who experience increased income.
3. Employees spend their increased income on more goods and services, generating still more growth.

“Those effects are felt at a local level and may appear at first glance to be fairly modest, but when you multiply these effects across the thousands of community banks in the United States, you really see how the lending decisions they make help the broader national economy.”

Ben Bernanke, Federal Reserve Chairman
Consistent Safe Payments Provide Foundation for Continued Prosperity

On a daily basis, all participants in local or global transactions take for granted that their payments will be sent and received in a safe and convenient manner. Consumers, businesses and governments on both ends of a transaction—like paying for lunch, delivering a package across the world or paying a municipal utility bill—know the payment will be easily transferred from one end to the other. This assurance increases our collective prosperity.

We save time, because commonly accepted and convenient forms of payment do not require research or vetting on a transaction-by-transaction basis. We have confidence that payments will be cleared in an efficient and timely manner without follow-up monitoring. This allows each of us to focus time and energy on productive activities that increase our household income, leading to the increased prosperity of our community and nation.

In addition, we know that all forms of payments—built on the rails of the regulated banking sector—will be transmitted securely due to best industry practices and applicable laws. Bank account information is protected while the payments occur in a convenient manner. Again, this allows us all to focus on activities that enrich our lives and lead to prosperity.

Banks Aid in Offsetting Our Nation’s Trade Deficit

Another way that banks contribute to the nation’s prosperity is by reducing the U.S. trade deficit. In 2013, financial services added $81 billion to U.S. exports. Financial services make up nearly 30 percent of the U.S. trade service surplus.
Regulation

4,600
The Federal Reserve conducted this number of bank examinations in 2012.

3,137
The OCC had this number of supervisory staff, 86% of its workforce, in 2012.

4,318
The FDIC directly examines and supervises this number of banks and savings banks.

$2.3 billion
FDIC had this amount of actual expenditures, completely funded by banks, in 2013.

$1 billion
The OCC’s 2013 operating budget was entirely paid for by the banking industry.
Regulation

Banks are one of the most heavily regulated U.S. industries, with rules and requirements surrounding every bank activity.

When it works well, bank regulation helps ensure the safety and soundness of the overall banking system. When it doesn’t, the natural cycle of facilitating credit, job growth and economic expansion is constricted. Finding the right balance is the key to economic prosperity.
Banks are heavily regulated by federal and state regulators. Federal bank regulators write rules to implement bank laws passed by Congress. Bank regulations cover every aspect of banking including safety and soundness and consumer protection. Regulatory responsibilities for banks include reporting suspicious activity to the government to prevent money laundering and other criminal activities.

There are many aspects that together form the regulatory environment in which banks operate, such as the level and complexity of the laws and regulations, how those laws are interpreted and enforced and the role of the field examiners who assure compliance. Each of these has an impact on the deposit–loan–jobs–prosperity cycle.

Finding the right regulatory balance is critical to assuring this cycle operates smoothly and maximizes potential growth. Since banks are not the only providers of credit and financial services, regulation not equally applied to nonbank competitors shifts activity out of regulated banks to these less-regulated providers.

As discussed in the next section, each bank is regulated by at least one primary regulator, depending on the bank’s charter. Banks may also be regulated by secondary regulators, as reflected in the outer circle of the diagram. Not all possible secondary regulators are shown in the diagram and some regulators are only relevant to those banks with a specific affiliated subsidiary.
Banks are subject to certain state laws, such as contract law, that are not preempted by federal law. Rules, regulations and supervision of international regulatory bodies also apply in those jurisdictions where banks do business. In addition, banks must increasingly adhere to applicable international bank standard setting bodies such as the Bank for International Settlements, including the Basel Committee on Bank Supervision and the Financial Stability Board.

**BANK AGENCIES AND EXAMINERS**

**Charter Type Determines Primary Regulator**

When a bank first gets started, it chooses among a number of different charter types. The charter represents legal authorization—similar to a business license—to engage in banking and is an agreement that the bank will carry out its activities in a safe and sound manner and adhere to the standards set forth by its regulators.

Banks can be chartered at either the state or federal level by their primary regulator. In addition, some banks and savings and loan associations have a holding company, a corporation that owns one or more banks or savings and loan associations. Most large bank holding companies and some other companies are registered as financial holding companies. This structure allows a bank institution to offer a broad range of financial services such as securities and insurance underwriting through subsidiaries or affiliated companies.

**Banking Institutions Charter Grantors, Examiners and Supervisors**

<table>
<thead>
<tr>
<th>Banking Institution Charter Type</th>
<th>Charter Grantor</th>
<th>Examiner/Supervisor</th>
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<tbody>
<tr>
<td>National, Federal</td>
<td>OCC</td>
<td>OCC</td>
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<tr>
<td>State</td>
<td>State financial services departments</td>
<td>State financial services regulator and FDIC or regional Federal Reserve Bank</td>
</tr>
<tr>
<td>Holding companies</td>
<td>Federal Reserve Board/ state corporate departments</td>
<td>Federal Reserve Board</td>
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</table>

**DID YOU KNOW?**

We have had a dual banking system for about 150 years. In 1863 after 80 years of state bank regulation, the National Bank Act offered banks the choice of a state or federal charter.
“Diversity increases the chances that innovative approaches to policy problems will emerge... A sole regulator, not subject to challenge from other agencies, might tend to become entrenched, conservative, and shortsighted.”

U.S. Department of the Treasury

The Office of the Comptroller of the Currency (OCC) is an independent agency within the Treasury Department that oversees federally chartered banking organizations. National banks and federal thrifts are examined by the OCC to determine their financial condition, the safety and soundness of their operations and their compliance with applicable laws.

The Federal Reserve oversees state banks that choose to become a member of the Federal Reserve (Fed member banks). It also supervises bank holding companies and savings and loan holding companies.

The Federal Deposit Insurance Corporation (FDIC) is the primary federal banking supervisor of non-Fed member banks and savings associations for safety and soundness and for compliance with the consumer financial protection laws and regulations. FDIC, as the federal insurer of deposits, may also participate in examinations of other federal bank regulators and has backup authority to examine banks with federal charters and Fed member state banks.

State financial services regulators examine state-chartered banks for safety and soundness and compliance with consumer financial protection laws and regulations. State banking regulators typically alternate onsite examinations with the FDIC.

Supervising Other Activities in the Banking Organization

Additional or secondary regulators supervise other operations of the banking organization—including affiliates and subsidiaries.

The Consumer Financial Protection Bureau (CFPB) is the primary rule writer for consumer financial protection that applies to all bank and nonbank financial institutions of all sizes. The CFPB directly examines banks with assets over $10 billion as well as large nonbank providers of consumer financial services.

DID YOU KNOW?
Thirty-eight percent of the FDIC’s 2013 expenditures went to examinations and supervision of the banking industry.

The Strength of Our Dual Banking System

The United States has a strong and innovative banking system, in large part because banks have the choice of being chartered by the state or federal government. This choice of charters is referred to as the dual banking system. It creates a healthy, dynamic tension among regulators leading to a wider range of products and services available to consumers, lower regulatory costs and more effective supervision.

The U.S. dual banking system has played an important role in bringing beneficial and productive changes to consumers and the economy as a whole. These changes have included federal deposit insurance, interest bearing checking accounts and trust services.
The Securities and Exchange Commission (SEC) oversees stock exchanges, broker-dealers, investment advisers and mutual funds. It also enforces securities law. The SEC oversees the affiliates of banks that are broker-dealers or investment advisers.

The Commodity Futures Trading Commission (CFTC) oversees commodity and futures exchanges. Among other things, the CFTC regulates interest rate and foreign exchange swaps. Many banks use swaps to mitigate risk either for the bank or for client portfolios.

The Municipal Securities Rulemaking Board (MSRB) regulates municipal securities dealers. Banking organizations that work with municipalities to develop municipal bond offerings may be subject to regulation by the MSRB.

Protecting Against Fraud and International Crime

Banks help the federal government fight fraud and international crime by enforcing rules from the Bank Secrecy Act (BSA) and by blocking transactions with individuals or companies that are prohibited for U.S. citizens. The two agencies that are most closely involved with this work are the Financial Crimes Enforcement Network (FinCEN) and the Office of Foreign Assets Control (OFAC).

FinCEN seeks to detect and deter financial crime by enforcing BSA rules governing anti-money laundering and counter-terrorism financing. Banks identify and report suspicious activity, including organized crime, money laundering and terrorist acts. Reports on suspicious activity and large cash transactions are managed by FinCEN and shared with federal and state law enforcement entities.

OFAC maintains the list of blocked companies and individuals whose assets should be blocked. This list is called the Specially Designated Nationals list (SDN). Banks monitor all financial transactions to detect those that involve any SDN. Banks block transactions or freeze accounts and then report to OFAC on these transactions or accounts.

“A system in which banks have choices, and in which regulations result from the give and take involving more than one agency, stands a better chance of avoiding the extremes of supervision.”

Alan Greenspan, Former Federal Reserve Chairman

DID YOU KNOW?

Banks and other financial institutions file about 57,000 Currency Transaction Reports (CTRs) each work day. CTRs are reports of currency transactions by one person that exceed $10,000.

A Culture of Compliance and Fair Treatment

Bankers serve their customers as trusted providers within a culture of compliance that strives to deliver services right from the beginning—and to self-correct any problems that may arise. This culture is set from the top—the board of directors—and reaches down to branch managers, loan officers, tellers and other staff. Banks invest significant amounts in adopting systems and training employees to assure they are fulfilling their legal responsibilities, so that customers can make their own informed and responsible choices. Fair treatment of customers is the law and the ethic that bankers abide by and to which they are held accountable by their regulators. Bankers do not shy from this standard—but they do expect competing financial service providers to meet the same standards and receive the same degree of supervisory oversight.
Bank Examiners use CAMELS to Rate Banks

Federal bank regulators use a rating system known as CAMELS to assign uniform ratings to banking institutions. Evaluation of the six performance areas included in the rating includes consideration of the bank’s size and sophistication, the nature and complexity of its activities and its risk profile.

- **Capital adequacy**—Maintaining adequate capital given the nature and extent of each bank’s risks
- **Asset quality**—Amount of existing and potential credit risk of the bank’s assets
- **Management**—Board of directors, and management’s ability to identify, measure, monitor and control the bank’s risks
- **Earnings**—Quantity and trend as well as sustainability or quality of earnings
- **Liquidity**—Ability to maintain enough liquid funds to meet financial obligations in a timely manner and to fulfill legitimate banking needs of the bank’s customers and community
- **Sensitivity to market risk**—How changes in interest rates, foreign exchange rates, commodity prices or equity prices could adversely affect a bank’s earnings or economic capital

Banks receive a rating for each area and an overall CAMELS rating ranging from 1 to 5—with 1 as the highest—indicating strong performance and risk management practices.
Principles of Effective Examination and Supervision

Bank supervision should add value to enhance the safe and sound management of individual banks and the stability of the banking industry. Successful supervision facilitates the deposit–loan–job–prosperity cycle that is so crucial for economic growth, while ineffective supervision stymies such growth.

Examiner decision making that is rooted in the fundamental principles of accountability, transparency and quality assurance helps keep the balance and moves towards the shared industry and policy maker goal: strong, healthy banks meeting customer needs. While debate continues on lessons learned from the financial crisis, several key principles for effective supervision that add value to banks and their customers have emerged:

- **Customized Supervision**
  The banking industry is as diverse as the customers it serves. Supervision should be tailored to a bank’s business model, its record with borrowers, the characteristics of its borrowers and other factors that lower bank risk. Complexity, not size, is the key.

- **Big-Picture Focus**
  Adding value is best achieved by a risk-based approach that looks for significant patterns or practices that, if unaddressed, would affect the viability of the bank. Focusing on minor issues or technicalities shifts examiner and bank resources to less critical functions.

- **Clear Examination and Regulatory Guidance on Bank Requirements**
  Clarity and predictability of examiner standards and expectations naturally help banks to manage their business in a straightforward way. Without this, uncertainty leads to excessive caution and less credit.

- **Experienced Examiners**
  Knowledgeable examiners with experience across economic cycles add value. Training programs ensure sound judgments.

- **Timely Examination Reports**
  Just as important as onsite examinations is the timely issuance of examination reports. The review process can often create delays which only add uncertainty and confusion.

- **Independent Appeal of Examination Ratings**
  A meaningful appeals process must be in place to resolve disputes. Appealing up the regulatory agency chain that made the exam determination does not provide confidence that an appeal review will be fair or lack retribution.

**DID YOU KNOW?**

Banks with a “CAMELS" rating of 4 or 5 are on the FDIC’s “Problem Bank List.”
After the financial crisis, many industry participants expected adjustments in bank examination, supervision and regulation. Post-crisis, the Dodd-Frank Act, a bill with 848 pages, was enacted, creating about 400 rules that are likely to take years to fully promulgate. The impact of this law has wide-ranging implications for institutions of all sizes. Shifting the bank regulatory balance to too much regulation in the post-crisis era has important consequences.

Dodd-Frank Act Has Hundreds More Pages Compared to Landmark Bank Acts

Dodd-Frank Act (2010): 848 pages
Gramm-Leach-Bliley Act (1999): 144 pages
Riegle-Neal Interstate Banking Act (1994): 44 pages
The Glass-Steagall Act (1933): 34 pages
Federal Reserve Act (1913): 25 pages

Number of Pages
Source: Statutes at Large

Learn about Dodd-Frank issues that affect community banks at aba.com/doddfrankact.

For regular updates on Dodd-Frank implementation go to regreformtracker.aba.com.
COSTS IMPACT CUSTOMERS

Bank regulatory changes—through each and every law and regulation, court case and legal settlement—directly impact the cost of providing banking products and services to customers. Even small changes can have a big impact on bank customers, by reducing the credit available to them, raising the cost of services, diminishing job creation and driving the consolidation of smaller banks. Anyone who uses banking products or services on a daily basis is affected by changes in bank regulation.

Regulatory pressures affect banks in different ways, including impacting bank capital. Since the capital base supports every loan that is made, these pressures can actually harm the ability of banks to meet the credit needs of customers.

- **Aggressive regulation** makes scarce investment capital move to other businesses.
- **Higher capital requirements** tie up more funds, limiting the amount of loans a bank can extend to businesses.
- **Restrictions on capital sources** diminish the amount of capital banks can use to support lending.

Unnecessary compliance requirements also lead to higher expenses, which reduces resources devoted to lending. When banks’ sources of income are reduced by laws, regulations or rules, they have less money to lend to customers. For example, the Durbin Amendment from the Dodd-Frank Act set limits on debit card transaction fees, one source of income for banks that helped to offset the cost of providing checking accounts with debit cards. This important source of revenue helped to provide free or low-cost accounts, which helped banks serve low-and moderate-income customers. Banks now have less money for the cost of services that customers demand. This leads to higher prices for customers.

Oversight Actions that Directly Impact Lending

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<th>Action</th>
<th>Loan Impact</th>
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<tr>
<td>▲ Regulatory Compliance</td>
<td>▼ Lending</td>
</tr>
<tr>
<td>▼ Sources of Income</td>
<td>▼ Lending</td>
</tr>
</tbody>
</table>

**DID YOU KNOW?**

Since 2008, 1,484 community banks have disappeared.

**DID YOU KNOW?**

International requirements—such as Basel III capital initiatives—can have an enormous impact on the lending of U.S. banks, particularly when the standards are applied to community banks, which are neither complex nor international in scope.

**DID YOU KNOW?**

One dollar in capital supports up to $10 in loans.
Costs Lead to Consolidation

The costs of new or changing requirements hit smaller banks particularly hard. They simply do not have the staffing to easily manage constantly changing regulations. The high compliance and other costs associated with an unbalanced regulatory environment will force some banks to shut their doors, leaving their communities without an important business partner.

DID YOU KNOW?
Almost 90 percent of acquired banks from 2000 to 2010 were community banks.

Internal costs are only a part of the cost increases banks face with unbalanced regulation. Banks must also pay for regulators’ increased costs. Bank regulators’ budgets, including salaries, are almost entirely dependent on fees that banks pay and are not funded by taxpayer dollars through the federal appropriations process.

Another long-term impact of an unbalanced regulatory environment is weaker job and economic growth. As banks adjust to many new or more stringent requirements, they will be less willing to take risks and extend credit. Higher-cost and less-available credit will slow or impede the deposit–loan–jobs–prosperity cycle.

Finally, this type of regulatory environment pushes banking and financial services activity to less regulated sectors. Borrowers seek alternatives to meet their needs and investors will move capital out of banks to businesses with similar activities but with lower costs or higher returns.
There are many institutions that offer bank-like products and function without the same level of regulation as banks. This additional competition can foster innovation and illustrate the benefits of a free market. But unsupervised and unchecked financial innovation, especially as it expands throughout our entire financial system, can pose risks to individuals and to the system as a whole.

When bank regulations become increasingly restrictive to banks and their customers, purchases of regulated bank products and services migrate from the safety and soundness of the banking system to similar but underregulated or unregulated products and services in the nonbanking system. In these cases, financial service providers, regulators and consumers are not better off as potential systemic risks and threats to financial stability grow undetected.

“The new banking standards may encourage certain activities to move to the nonbank sector, where those standards do not apply.

Alternatively, big banking groups with advantages of scale may be better able to absorb the costs of the regulations; as a result, they may become even more prominent in certain markets, making these markets more concentrated.”

Bank Competition

250%
Tax-exempt credit unions have grown over twice the rate of taxpaying banks.

209
This many credit unions, with over $1 billion in assets, are larger than 90% of banks.

50%
The Farm Credit System pays very little in taxes and holds this percent of farm business debt.
Nonbanks

Other financial institutions and financial products add complexity and risk to the delivery of financial services. Supervision and regulations are not identical between banks and nonbanks offering comparable products. This can create a dynamic where capital, resources and risk shift to the lightly regulated sector and banks can not compete. Understanding nonbanks is critical to understanding the business of banking.
There are many institutions that offer bank-like products and functions without the same level of regulation as banks.

When bank regulations become increasingly restrictive to banks and their customers, purchases of regulated bank products and services migrate from the safety and soundness of the banking system to similar but underregulated or unregulated products and services in the financial system. In these cases, financial service providers, regulators and consumers are not better off.

As more financial activity becomes under-or unregulated, more and more activities lack proper monitoring or backstop and can foster undetected growth of potential systemic risks and threats to financial stability.

When Bank Regulations Are Restrictive
the Market Moves to Underregulated Businesses
Credit unions were originally based on the simple concept of bringing together a close-knit group of people to pool their resources and provide small loans to one another. Their focus was on individuals with limited resources who might not otherwise have access to financial services. Commonality of interest, or common bond, was the essence of credit union membership.

While this model remains true for many smaller credit unions, increasingly, credit unions have simply grown beyond recognition, altering their charters in order to include millions of people within their field of membership. They are also offering a wide range of complex financial products and are providing financial services to individuals that lie outside the scope of the traditional credit union mission to serve people of modest means. Even to the untrained eye, these morphed credit unions look and act much more like retail banks than credit unions.

But, there is one important difference—their are still not subject to federal income taxes, and this gives them a significant competitive advantage when they compete directly for the same customers with banks, especially community banks. It is now the case that many community banks compete with credit unions that are bigger than they are. Since all competition is local, this puts banks in every community at risk.

**BACKGROUND**

**What Credit Unions Used to Be**

The first credit union in the United States, St. Mary’s Bank, was established in New Hampshire in 1908. In 1934, Congress established federal credit unions to provide small loans to people of modest means, and in return credit unions were granted a tax exemption by Congress. To be eligible to join a credit union, a person had to become a member of the credit union, and membership was limited to those with a common bond, such as working for a specific company or belonging to a specific union.

**DID YOU KNOW?**

Savings associations and mutual banks that are very similar to the credit union structure were once tax exempt. These institutions, unlike credit unions, have paid taxes since 1951 while continuing to serve their owner-members.
Credit Unions Serve High-Income Customers Not Those of Modest Means

The rapid growth of the credit union industry has been accompanied by significant changes in membership demographics. The focus on “people of small means” was clearly enunciated in the preamble to the Federal Credit Union Act. This vision has disappeared in many cases as this new breed of credit unions caters to wealthier customers.

DID YOU KNOW?
There are over 200 credit unions with assets greater than $1 billion, making them bigger than 90 percent of banks.

Tax Subsidy Benefits Rapid Growth of Large Credit Unions

Over time, credit unions have evolved from “small mom and pop” organizations into full-service competitors with banks. They use their privileged tax exemption to grow. In addition, the liberalization of field of membership requirements and the expansion of credit union powers has fueled this rapid growth in the credit union industry.

In fact, the tax subsidy benefits the largest credit unions. These credit unions are taking full advantage of their tax subsidy to grow, more than quadrupling in number since 2000. Some of these large credit unions are growing by acquiring smaller credit unions and some are even using their preferential tax treatment to acquire taxpaying banks. Large credit unions produce over three-fourths of the industry’s profits, but paid $0 in federal income tax.

DID YOU KNOW?
Tax breaks mean that credit unions have not paid an estimated $20.5 billion in federal corporate income taxes.

Video: Is Taxing Credit Unions Good Business?
The tax subsidy has also been used by credit unions to build large headquarters, to buy the naming rights to arenas and to sponsor sporting events.

Congress Limited Large Business Loans

Credit unions are federally mandated to focus their lending to people of small means. Congress limited credit union business lending to 12.25 percent of the credit union’s assets. However, the law allows credit unions to make unlimited small business loans of less than $50,000 that do not count towards their business lending limit.

Community banks make 32 percent of all small business loans. Therefore, each business loan that a credit union takes from a bank is lost tax revenue. Credit unions do not pay federal income taxes. In addition, many credit unions that have rapidly expanded their business lending failed, revealing a lack of business lending expertise and controls. This higher risk is another reason why Congress limited business lending of credit unions, particularly for large loans that could quickly lead to large losses if managed poorly.

DID YOU KNOW?

The GAO found that small business lending at large credit unions increased from about 2 percent of loans in 2002 to nearly 8 percent in 2011.
Congress created the Farm Credit System (FCS) in 1916 to serve the needs of family farmers and ranchers. With help from its benefactors in Congress and its regulator, the Farm Credit Administration (FCA), the FCS has grown dramatically. It competes directly with banks for farm, ranch, home mortgage, agribusiness, consumer, energy and cooperative loans and is the only government sponsored enterprise that competes directly with private-sector lenders. In fact, the FCS has increased its share of farm business debt from 28 to 41 percent since 2000; banks’ share over the period declined from 46 to 40 percent.

The FCS is organized as a cooperative and has a nationwide presence, operating approximately 82 institutions with thousands of retail offices. Many of these institutions are multibillion-dollar companies in their own right.

The Farm Credit System has had significant earnings, but paid very little taxes. For example, in 2012 its assets were $237 billion and it had earnings of more than $4.1 billion, but it only paid an effective tax rate of 5.1 percent. In contrast, in 2012 the banking industry paid an effective income tax rate of about 30 percent.
Deposit-like Prepaid Cards Are Offered by Nonbanks and Banks

There are different types of prepaid cards. An “open loop” card can be used at many different merchants and may even provide access to ATM networks. If the account underlying this card can be increased, it is known as a “general purpose reloadable card,” and it shares many attributes of a typical debit card issued by a bank. In contrast, a “closed loop” card can only be used to make purchases at a limited number of merchants, usually one merchant or mall.

While many banks offer general purpose reloadable cards, some nonbank entities, like retailers, also offer this product to consumers. Retailers offer general purpose reloadable cards that are issued by both banks and nonbanks. Both bank and nonbank issuers are responsible for ensuring that parties reselling their products are complying with applicable rules and regulations.

General purpose reloadable cards offer a path to financial inclusion to consumers who wish to have the convenience of making card purchases at millions of merchant locations, access funds via ATM withdrawals and receive direct deposit payments, but who may not want or qualify for a traditional checking account. Consumers that successfully manage a prepaid card account will benefit from avoiding check cashing fees and taking advantage of online bill payment services where available.

BACKGROUND

FinCEN Rule Applies to Bank and Nonbank Prepaid Cards

In 2011, Financial Crimes Enforcement Network (FinCEN) issued a final rule governing prepaid access programs to address regulatory gaps with existing prepaid programs. One example was the retail distribution model for prepaid cards where nonbanks were offering bank-like products outside of a controlled environment and the BSA regulatory framework in which banks operate.

FinCEN’s rule defined providers and sellers of prepaid access and established a regulatory framework for those participants. Certain products were deemed inherently low risk and not covered by the rule: closed loop products that do not exceed $2,000 in value on any one day; government-funded prepaid access products, including federal, state, local, territory, insular possession and tribal government agency products; and flexible spending and dependent card funded prepaid access products. Two other types of products, payroll products and small dollar products, were also deemed low risk, provided they cannot be used internationally, are restricted to who may load funds and do not permit person-to-person transfers.
There are many conflicting definitions of “shadow banking,” a term coined in the wake of the financial crisis. It is applied to a number of markets that were a cause for concern during the financial crisis, among them securitization and money market mutual funds (MMMFs).

The term “shadow banking” is problematic. “Bank” is a misnomer, since it implies a single institution. The market activities that are commonly covered in a definition of shadow banking involve a variety of institutions, including banks and nonbanks. “Shadow” is also a misnomer, as each market activity commonly included is subject to regulatory oversight mechanisms both at the product and at the entity level.

If “shadow banking” is not an accurate description of these markets, what is? The function performed by “shadow banking” is similar to the basic funding mechanism performed by banks—turning deposits into loans. To address the risks inherent in this basic funding mechanism, banks are highly regulated. In “shadow banking,” this funding mechanism occurs within the capital markets—in a series of steps that involve a number of products and entities—instead of within a single bank. We will refer to it as capital markets funding. These activities similarly involve risks that became evident during the crisis.

**DID YOU KNOW?**

One percentage point equals 100 basis points. A yield of 1 percent that increases by 25 basis points would be written as 1.25 percent.
Pros and Cons

As with any activity, there are pros and cons to capital markets funding. Securitization provides benefits to the economy by enabling lenders, including banks of all sizes, to sell their assets and make new loans using the proceeds. See page 33 for a description of securitization and its benefits.

MMMFs also benefit our economy. Investors such as corporations and state and local governments use MMMFs for cash-flow purposes, and to fund their operations. MMMFs invest in short-term securities of corporations, including banks, and governments. Individual investors view MMMFs as a place to hold temporary cash until they need it, and they value them as a way to participate in the securities markets without worrying about diversification.

There are also cons to capital markets funding when compared to traditional bank funding. Some of the products, such as MMMFs, compete directly with traditional depository products. The activities involved in capital markets funding contain risks, some of which have the potential for systemic effects. The financial crisis made it clear that these risks had to be properly mitigated. For example, during the panic in September 2008, investors withdrew funds from numerous MMMFs. To stem the panic, Treasury temporarily guaranteed all funds in MMMFs that agreed to participate in the guarantee program. While the guarantee remained unused until its expiration, it was effective in stopping the panicked MMMF withdrawals. Securitization, too, was heavily impacted by the financial crisis, particularly mortgage securitization.

In the wake of the financial crisis, legislators, regulators and industry participants have focused attention on policy changes that would enhance regulation of capital markets funding, including MMMFs and securitization, to address flaws that became evident during the crisis. Some of these changes have already been implemented while others are in the process of being implemented.

“U.S. banks have raised their private capital levels to approximately $1 trillion, up 75 percent from $578 billion three years ago. Our financial institutions are also less reliant on the so-called ‘shadow banking system’ for funding.”

Under Secretary for Domestic Finance of Treasury Mary Miller
Glossary of Terms
advisory service Advice, both financial and otherwise, provided for a fee

asset Anything owned by a business or individual that has commercial, exchange or book value; a loan is a common bank asset but a common borrower liability

asset management An advisory service where a customer's financial assets are professionally managed

bank capital The funds invested in a bank on a long-term basis. Capital is obtained by issuing preferred or common stock, retaining a portion of its earnings for long-term borrowing.

bank secrecy act Adopted in 1970, the Currency and Foreign Transactions Reporting Act requires banks to maintain records and provide information to federal authorities for combating financial crimes and terrorist financing.

basel III A comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector

bill of exchange A draft, such as a check or trade acceptance, addressed and signed by one person to another. The receiving person must pay a specified sum, on demand or at a specific future time

bank for international settlements (BIS) An international organization founded in 1930 to serve central banks, works towards international cooperation on monetary and financial stability and acts as a counterparty for central bank transactions

broker-dealer A party that makes securities transactions on behalf of its customers as well as for its own market position and may serve the customer as either a broker or a dealer

card issuer A bank or organization that issues, or causes to be issued, bank cards to people who apply for them
check clearing  The process by which a check is presented to and accepted by the financial institution on which it is drawn

credit cycle  The cycle of taking in deposits and making loans that leads to jobs and increased income throughout the economy and then leads to more deposits

custody account  An account for which the custodian safeguards, preserves, and performs administrative duties for the property as directed by the principal, but has no investment or managerial responsibilities

defined benefit plan  A pension plan guaranteeing the payment of a specified benefit at retirement with actuarially determined annual contributions sufficient to produce the specified benefit

defined contribution plan  A pension plan with an individual account for each participant and for benefits based on contributions to the participant’s account, including income, expenses, gains or losses

derivative  A financial product with a return based on another underlying asset

estate planning  Determining how to maximize the after-tax value of an estate and taking steps to accomplish that end or measuring a person’s estate before the person dies and determining how it will be distributed

farm credit system  A cooperative group of lending associations created in 1916 by Congress to provide real estate and production loans to farmers, ranchers, fishermen and other designated rural borrowers

fiduciary  A person or trust institution charged with the duty of acting for the benefit of another party on matters coming within the scope of the relationship between them

field examiner  A local bank examiner tasked with carrying out the actual bank exam and usually overseen by the regulator’s regional and Washington, D.C., offices

field of membership  The persons (including organizations and other legal entities) a federal credit union is permitted to accept for membership

financial stability board (FSB)  An international organization established in 1999 by the G20 countries to address systemic vulnerabilities and to develop and implement strong regulations and supervision to assure global financial stability
**gross domestic product (GDP)**  A country’s total output of goods and services from all forms of economic activity measured at market prices for a calendar year.

**government sponsored enterprise (GSE)**  A quasigovernmental organization that is privately owned but created by the government. GSEs have the implicit backing of the U.S. Treasury.

**hedge fund**  A private investment that employs complex investment strategies and is generally not available to the public. Investors in hedge funds are commonly institutions and wealthy individuals.

**interchange fee**  A fee paid by the retailer’s bank to the bank that issued the bank card used in the transaction. The fee pays the card issuer for the transaction services it provides and expenses and risks.

**intraday line of credit**  An extremely short-term loan of funds, up to a certain limit, that must be repaid the same day it was lent.

**investment management account**  An agency relationship that provided investment advice and portfolio management to individuals and institutions for a fee.

**irrevocable trust**  A trust that cannot be revoked by the settlor or can be terminated by the settlor only with the consent of someone who does not have an interest in its termination, such as a beneficiary.

**lockbox**  A banking service provided for the rapid collection of a customer’s receivables and rapid credit to the customer’s account.

**money market mutual fund (MMMf)**  A mutual fund that buys money market securities which usually are liquid and have little default risk and short maturities such that the funds typically keep the share value at $1.

**open-ended loan**  A loan where the borrower may draw on funds up to a credit limit preapproved by the bank.

**payment system**  The transaction clearing and settlement system that electronically verifies and authenticates transaction information for bank payment transactions, including bank card transactions.

**private foundation**  A charitable organization that does not qualify as a public charity under the Internal Revenue Code.
promulgate  To make public notification or to make a rule or regulation, usually by an authorized government body

remote deposit capture  Started with businesses scanning checks and transmitting the encrypted images to a bank; today can also be a deposit made using a smartphone application and camera

resident examiner  An examiner from a bank regulator who has a continuous, onsite presence at the bank as the examiner’s permanent work location

revocable trust  A trust agreement that can be altered or terminated by the person establishing the trust.

sweep account  The prearranged automatic transfer of temporary funds from a checking account into an interest-bearing account.

trade deficit  The amount by which a country’s imports exceed exports

trade service surplus  The amount by which a country’s service sector exports exceed the same sector’s imports

trustee  A person or trust institution that holds the legal title to property for the benefit of someone else. A trustee is responsible for preserving and managing the assets of a trust.

trust  A fiduciary relationship in which a person or corporation (the trustee) holds the legal title to property (the trust property). The trustee is subject to an obligation, enforceable in court, to keep or use the property for the benefit of another person (the beneficiary).

underwriting  The process of evaluating an applicant for a mortgage or other type of loan for creditworthiness before extending the loan.

unsecured  Debt or loan not backed by a pledge of issuer’s assets or collateral, or collateral worth less than the amount loaned respectively