UNIT 6

BANKING

6.1 Getting started.

Because banking plays such a major role in channeling funds to borrowers with productive investment opportunities, its financial activity is important in ensuring that the financial system and the economy run smoothly and efficiently. In the United States, banks (depositary institutions) supply more than $6 trillion in credit annually. They provide loans to businesses, help people finance their college educations or the purchase of a new car or home, and provide them with services such as checking and savings accounts.

In this unit, we examine how banking is conducted to earn the highest profits possible: how and why banks make loans, how they aquire funds and manage their assets and liabilities (debts), and how they earn income. Although we focus on commercial banking because this is the most important financial intermediary activity, many of the same principles are applicable to other types of financial intermediation.

Discuss the following points.

1. How does the financial system make sure that your hard-earned savings get channeled to those with productive investment opportunities?
2. Do you really think that financial institutions promote economic efficiency?
3. Why do you think financial intermediaries are more important than securities markets for getting funds to borrowers?

6.2 Look through the following vocabulary notes which will help you understand the text and discuss the topic.

an account	счет; Бр. англ. отчет
accounting	бухгалтерский учет
a statement of account	выписка о состоянии счета

accounting equation to service accounts to debit an account to credit smth to an account an accountant a savings account	бухгалтерское тождество обслуживать счета дебетовать счет кредитовать счет бухгалтер сберегательный счет
to acquire, syn. to obtain	приобрести, получить
to manage management	управлять управление
assets asset management asset holdings income-earning assets	активы управление активами владения активами доходные активы
liabilities to issue liabilities liability management	обязательства выпускать обязательства управление обязательствами
a balance sheet	балансовый отчет
a deposit to deposit a depositor to maintain deposits a demand deposit, synonyms: a checkable deposit, a checking account a time deposit a transaction deposit a non-transaction deposit a certificate of deposit (CD)	вклад, депозит вносить, депонировать вкладчик держать вклады депозит до востребования син. чековый депозит, чековый счет, текущий счет срочный вклад/депозит транзакционный счет (текущий счет, краткосрочный депозит) не транзакционный счет (срочный депозит) депозитный сертификат
a loan to issue a loan a commercial loan a real estate loan a consumer loan an interbank loan	ссуда, заем, кредит выдать ссуду коммерческая ссуда ссуда под залог недвижимости потребительский ссуда межбанковская ссуда
to denominate small denomination large denomination	деноминировать мелкого достоинства крупного достоинства

to borrow a borrower borrowing	взять в долг заемщик займы, долги, одалживаемые средства
a bank teller	кассир банка, служащий банка
a passbook	сберегательная книжка
to assess penalties	начислять штрафы
a check to present a check for payment to draw a check on an account to clear a check	чек представить чек к оплате выставить чек на счет провести расчет по чеку
to bear a bearer a bearer instrument	нести предъявитель финансовый инструмент на предъявителя
NOW accounts (negotiable order of withdrawal)	нау-счет, текущий счет с выплатой процента и списанием по безналичным расчетам
MMDAs (money market deposit accounts)	депозитный счет по ставкам денежных рынков
payable on demand/at sight	подлежащий оплате по предъявлению
liquid liquidity liquidity management	ликвидный ликвидность управление ликвидностью
negotiable non-negotiable	обращаемый не обращаемый
a bank holding company	банковская холдинговая компания
a repurchase agreement	репо, договор о продаже с последующим выкупом по обусловленной цене
a foreign branch	зарубежный филиал
Bank Capital, syn. bank's net worth, net assets, equity	капитал банка, чистая стоимость банка
a cushion	подушка безопасности
solvency,	платежеспособность

ant. insolvency	неплатежеспособность
in excess of	с превышением над
liquidation	ликвидация
the Fed (Federal Reserve System)	Федеральная резервная система США
vault cash	наличность в хранилище
a return on	доход/прибыль от
collection	инкассо, сбор причитающихся платежей
to correspond corresponding relationships a corresponding bank	корреспондировать корреспондентские отношения корреспондирующий банк
to mature maturity a fixed maturity a maturity date	подойти к сроку погашения срок погашения фиксированный срок погашения; дата погашения
to default a default default risk	отказаться выплатить долг отказ от выплаты долга риск не возврата долга/ссуды
option	опцион
swap	своп
financial futures	финансовые фьючерсы
financial derivatives	финансовые деривативы
to make a bet	сделать ставку
internal controls	система внутреннего контроля
regulators bank regulation	регулирующие/контролирующие органы банковское регулирование
Barings Bank	Банк Бэрингс

6.3 Reading

The Bank Balance Sheet

To understand how banking works, we start by looking at the bank balance sheet, a list of the bank's assets and liabilities. As the name implies, this list balances; that is, it has the characteristic that

total assets = total liabilities + capital.

A bank's balance sheet is also a list of its sources of bank funds (liabilities) and uses to which the funds are put (assets). Banks obtain funds by borrowing and by issuing other liabilities such as deposits. They then use these funds to acquire assets such as securities and loans. Banks make profits by charging an interest rate on their asset holdings of securities and loans that is higher than the interest and other expenses on their liabilities. The balance sheet of all commercial banks at the beginning of 2007 appears in Table 1.

Table 1 Balance Sheet of All Commercial Banks (items as a percentage of the total, end of 2007)

ASSETS (Uses of Funds)*		**LIABILITIES (Sources of Funds)**	
Reserves and cash items	3%	**Checkable deposits**	6%
Securities U.S. government and agency State and local government and other securities	 12 11	**Non-transaction deposits** Small-denomination time deposits (less than $100,000+savings deposits) Large-denomination time deposits	 40 19
Loans Commercial and industrial Real estate Consumer Interbank Other	 12 34 7 4 9	**Borrowings**	26
Other assets (for example, physical capital)	8	**Bank capital**	9
Total	100	**Total**	100

***In order of decreasing liquidity**

LIABILITIES

A bank acquires funds by issuing (selling) liabilities, such as deposits, which are the *sources of funds* the bank uses. The funds obtained from issuing liabilities are used to purchase income earning assets.

Checkable deposits Checkable deposits are bank accounts that allow the owner of the account to write checks to third parties. They include all

accounts on which checks can be drawn: non-interest-bearing checking accounts (demand deposits), interest-bearing NOW (negotiable order of withdrawal) accounts, and money market deposit accounts (MMDAs). Checkable deposits and money market deposit accounts are payable on demand; that is, if a depositor shows up at the bank and requests payment by making a withdrawal, the bank must pay the depositor immediately. Similarly, if a person presents a check at the bank, it must pay the funds out immediately or credit them to that person's account. The bank's costs of maintaining checkable deposits include interest payments and the costs incurred in servicing these accounts – processing, preparing, and sending out monthly statements, providing efficient tellers, maintaining an impressive building and conveniently located branches, and advertising and marketing to entice customers to deposit their funds with a given bank.

Non-transaction deposits Non-transaction deposits are the primary source of bank funds (59% of bank liabilities in Table 1). Owners cannot write checks on non-transaction deposits, but the interest rates paid on these deposits are usually higher than those on checkable deposits. There are two basic types of non-transaction deposits: savings accounts and time deposits (also called certificates of deposit, or CDs). In savings accounts, to which funds can be added or from which funds can be withdrawn at any time, transactions and interest payments are recorded in a monthly statement or in a passbook held by the owner of the account. Time deposits have a fixed maturity length, ranging from several months to over five years, and assess substantial penalties for early withdrawal. Small-denomination time deposits (deposits of less than 100,0000) are less liquid for the depositor than passbook savings, earn higher interest rates, and are more costly source of funds for the banks. Large-denomination time deposits (CDs) are available in denominations of $100,000 or more and are typically bought by corporations or other banks. CDs are negotiable; like bonds, they can be resold in a secondary market before they mature. For this reason, negotiable CDs are held by corporations, money market mutual funds, and other financial institutions as alternative assets to Treasury bills and other short-term bonds.

Borrowings Banks also obtain funds by borrowing from the Federal Reserve System, other banks, and corporations. Other sources of borrowed funds are loans made to banks by their parent companies (bank holding companies), loan arrangements with corporations (such as repurchase agreements), and borrowings in Eurodollars in foreign banks or foreign branches of U.S. banks.

Bank Capital_ The final category on the liabilities side of the balance sheet is bank capital, the bank's net worth, which equals the difference between total assets and liabilities. Bank capital is a cushion against a drop in the value of its assets, which could force the bank into insolvency (having liabilities in excess of assets, meaning that the bank can be forced into liquidation).

ASSETS

A bank uses the funds that it has acquired by issuing liabilities to purchase income-earning assets. Bank assets are thus naturally referred to as *uses of funds*, and the interest payments earned on the them are what enable banks to make profits.

Reserves All banks hold some of the funds they acquire as deposits in an account at the Fed. Reserves are these deposits plus currency that is held by banks (called vault cash because it is stored in bank vaults overnight).

Cash Items in Process of Collection Checks are classified as cash items in process of collection, and they are assets for the bank because they are claims on another bank for funds that will be paid within a few days.

Deposits at Other Banks Many small banks hold deposits in larger banks in exchange for a variety of services, including check collection, foreign exchange transactions, and help with securities purchases. This is an aspect of a system called correspondent banking.

Securities A bank's holdings of securities are an important income-earning asset. Securities are made up entirely of debt instruments for commercial banks, because banks are not allowed to hold stock. These can be classified into three categories: U.S. government and agency securities, state and local government securities, and other securities. The first are the most liquid because they can be easily traded and converted into cash with low transaction costs.

Loans Banks make their profits primarily by issuing loans. Loans are typically less liquid than other assets, because they cannot be turned into cash until the loan matures. Loans also have a higher probability of default than other assets. Because of the lack of liquidity and higher default risk, the bank earns its highest return on loans. The largest categories of loans for commercial banks are commercial and industrial loans made to businesses, and real estate loans. Commercial banks also make consumer loans and lend to each other. The bulk of these interbank loans are overnight loans lent in the federal funds market. The major difference in the balance sheets of the various depositary institutions is primarily in the type of loan in which they specialize. Savings and loans and mutual savings banks, for example, specialize in residential mortgages, while credit unions tend to make consumer loans.
Other Assets The physical capital (bank buildings, computers, and other equipment) owned by banks is included in this category.

6.4 Comprehension

6.4.1 Answer the questions using the active vocabulary.

1. What is the bank's balance sheet?
2. How does the list of the bank's assets and liabilities balance?
3. Which side of the balance sheet shows the sources of funds?
4. Which side of the balance sheet shows the uses of funds?
5. How do banks obtain funds?
6. How do banks use funds?
7. What do you think makes the profit of the bank?
8. What are the main items on the balance sheet which show its liabilities?
9. What are the main items on the balance sheet which show its assets?
10. Why do you think Bank Capital is shown on the liabilities side of the balance sheet?
11. What are checkable deposits ?
12. What is the difference between demand deposits, NOW accounts, and money market deposit accounts? (Use the glossary of unit 6 to give the appropriate answer.) Are they all payable on demand?

13. What is a check? (Use the glossary of unit 6 to give the appropriate answer.)
14. What are the bank's costs of maintaining checkable deposits?
15. Why do you think non-transaction deposits are the primary source of bank funds?
16. What are the two basic types of non-transaction deposits?
17. What is the difference between savings accounts and time deposits?
18. Why do you think they (savings accounts and time deposits) are called non-transaction deposits?
19. Why do you think time deposits assess substantial penalties for early withdrawal?
20. What does the term 'negotiable' mean?
21. For what reason are negotiable CDs held by corporations, money market mutual funds, and other financial institutions as alternative assets to Treasury bills and other short-term bonds?
22. Where can the bank borrow from?
23. What is the Bank Capital a cushion against?
24. What is the bank insolvency?
25. Can we say that deposits at other banks and cash items in process of collection can be collectively referred to as *cash items*?
26. What is correspondent banking?
27. Why do banks hold securities? What are the bank's holdings of securities made up of?
28. Why do banks prefer to hold the most liquid securities?
29. Why do you think banks are not allowed to hold stocks?
30. What is the primary source of the bank's profit?
31. Why are loans typically less liquid than other assets?
32. What is meant by the term 'default'?
33. What are the reasons for the bank's earning the highest rate of return on loans?
34. What kinds of loans do you know?
35. What makes the major difference in the balance sheets of the various depositary institutions?

6.4.2 Mark these statements T (true) or F (false) according to the information in the text. If they are false say why.

1. The list of the bank's balance sheet assets and liabilities balances according to the accounting equation (total assets = total liabilities + capital).
2. The bank's assets are referred to as *sources of funds* while the bank's liabilities are referred to as *uses of funds*.
3. Banks make profits by charging an interest rate on their asset holdings of securities and loans that is lower than the interest and other expenses on their liabilities.
4. The bank's holdings of securities are the major item of its assets.
5. The bank's savings and time deposits are the major source of its funds.
6. Non-interest-bearing demand deposits and interest-bearing NOW accounts are non-transaction deposits.
7. MMDAs and checkable deposits are payable on demand.
8. Interest paid on deposits (checkable and non-transaction) usually accounts for around 30% of total bank operating expenses, while the costs involved in servicing accounts (employee salaries, building rent, and so on) are approximately 50% of operating expenses.
9. There are two types of non-transaction deposits: CDs and demand deposits.
10. Owners can write checks on non-transaction deposits.
11. Interest rates paid on non-transaction deposits are lower than those on checkable deposits.
12. Savings accounts pay a lower interest rate than time deposits.
13. Savings accounts assess substantial penalties for early withdrawal.
14. Small-denomination time deposits are more liquid for the depositor than passbook savings.
15. Negotiable CDs are large-denomination time deposits.
16. Negotiable CDs are held by individuals while small-denomination nonnegotiable CDs are typically held by corporations and other banks.
17. Banks borrow reserves overnight in the federal funds market from other U.S. banks and financial institutions.
18. Eurodollars are U.S. banks' deposits denominated in the euro.

19. The Bank Capital is the bank's net worth.
20. The bank's deposits held in an account at the Fed are its vault cash because it is stored in bank vaults overnight.
21. Suppose that a check written on an account at another bank is deposited in your bank and the funds for this check have not yet been collected from the other bank. The check is classified as a cash item in process of collection.
22. Banks are allowed to hold stocks.
23. The U.S government and agency securities are the most liquid but they cannot be traded and converted into cash with low transaction costs.
24. Banks make their profits primarily by issuing loans and loans usually produce more than half of bank revenues.
25. Loans have a lower probability of default than other assets.
26. Among other assets are loans issued to consumers and other banks.

6.5 Language practice

6.5.1 Match the English terms in the left-hand column with the definition in the right-hand column.

1	Asset management	A	Bank activities that involve trading financial instruments and the generation of income from fees and loan sales, all of which affect bank profits but are not visible on bank balance sheets.
2	Reserves	B	A cost or benefit that motivates a decision or action by consumers, businesses, or other participants in the economy.
3	Incentive	C	A financial contract that obligates one party to exchange a set of

			payments it owns for a set of payments owned by another party.
4	Passbook savings account	D	The acquisition of funds at low cost to increase profits.
5	Loan sale	E	A situation in which the party issuing a debt instrument is unable to make interest payments or pay off the amount owed when the instrument matures.
6	Demand deposit	F	A date at which the principal on a bond or similar financial asset needs to be repaid.
7	Vault cash	G	The acquisition of assets that have a low rate of default and diversification of asset holdings to increase profits.
8	Bearer instrument	H	A form of a loan in which the borrower simultaneously contracts to sell securities and contracts to repurchase them, either on demand or on a specified date.
9	Maturity	I	An interest-bearing savings account held at a commercial bank.
10	Liquidity management	J	A deposit held by a bank that must be paid to the depositor on demand (more commonly called checking accounts).
11	Default	K	The sale under a contract (also called a secondary

			loan participation) of all or part of the cash stream from a specific loan, thereby removing the loan from the bank's balance sheet.
12	Repurchase agreement (REPO)	L	A bank-issued short-term security that is traded and documents a deposit and specifies the interest rate and the maturity date.
13	Off-balance-sheet activities	M	Currency that is physically held by banks and stored in vaults overnight.
14	Overnight cash rate	N	A situation in which the value of a firm's or bank's assets have fallen below its liabilities; bankrupt.
15	Liability management	O	A security payable to the holder or "bearer" when presented. No proof of ownership is required.
16	Insolvent	P	The decision made by a bank to maintain sufficient liquid assets to meet the bank's obligations to depositors.
17	Swap	Q	Banks' holding of deposits in accounts with the Fed, plus currency that is physically held by banks (vault cash).
18	Negotiable certificates of deposit	R	The interest rate for very short-term interbank loans.

6.5.2 Complete the following text using suitable words or phrases from the box below.

A	bank	**F**	long-term
B	depositor	**G**	low cost
C	credit analysis	**H**	assets
D	liabilities	**I**	transforming
E	short-dated	**J**	mortgage loan

Basic Banking

In general terms, banks make profits by selling ____1____ with one set of characteristics (a particular combination of liquidity, risk, size, and return) and using the proceeds to buy ____2____ with a different set of characteristics. This process is often referred to as *asset transformation*. For example, a savings deposit held by one person can provide the funds that enable the bank to make a ____3____ to another person. The bank has, in effect, transformed the savings deposit (an asset held by the ____4____) into a mortgage loan (an asset held by the ____5____). Another way this process of asset transformation is described is to say that the bank "borrows short and lends long" because it makes ____6____ loans and funds them by issuing ____7____ deposits.

The process of ____8____ assets and providing a set of services (check clearing, record keeping, ____9____, and so forth) is like any other production process in a firm. If the bank produces desirable services at ____10____ and earns substantial income on its assets, it earns profits; if not, the bank suffers losses.

6.5.3 Complete the text. Replace the Russian words and phrases by English equivalents.

General Principles of Bank Management

Let's look at how a bank manages its ***активами и обязательствами*** to earn the highest possible ***прибыль***. The ***управляющий банка*** has four primary concerns. The first is to make sure that the bank has enough ***наличность*** ready to pay its ***вкладчики***

when there are deposit outflows – that is, when deposits are lost because depositors make ***списание средств*** and demand payment. To keep enough ***наличность в кассе***, the bank must engage in ***управление ликвидностью***, the acquisition of sufficiently ***ликвидные активы*** to meet the bank's obligations to depositors. Second, the bank manager must persue an acceptably low ***уровень риска*** by acquiring assets that have a ***низкая степень*** of default and by diversifying asset holdings (***управление активами***). The third concern is to ***приобретать средства*** at low cost (***управление обязательствами***). Finally, the manager must decide the ***сумма капитала*** the bank should ***поддерживать*** and then acquire the needed capital (capital adequacy management).

6.5.4 Text for discussion.

a. Look up the dictionary for the meaning and pronunciation of the following words and word-combinations and use them to discuss the problems outlined in the text.

Banks' trading activities; management techniques; interest-rate risk; financial futures; options; swaps; foreign exchange markets; off-balance-sheet activities; to outguess the markets and engage in speculation; bank insolvencies; Barings bank; bets; financial derivatives; an incentive; excessive risks; internal controls; bookkeeping for trades; regulators; risk management.

b. Briefly scan the text and outline the list of major points.

c. Read the text more carefully and comment on the following items:

- the increased risk of off-balance-sheet activities of a bank;
- risk assessment procedures and internal controls to restrict employees from taking on too much risk;
- the importance of bank regulation;
- the dramatic failure of Barings, a British bank, in 1995.

Trading Activities and Risk Management Techniques

Banks' attempts to manage interest-rate risk have led them to trading in financial futures, options for debt instruments, and interest-rate swaps. Banks engaged in international banking also conduct transactions in the foreign exchange market. All transactions in these markets are off-balance-sheet activities because they do not have a direct effect on the bank's balance sheet. Although bank trading in these markets is often directed toward reducing risk or facilitating other bank business, banks may also try to outguess the markets and engage in speculation. This speculation can be very risky business and indeed has led to bank insolvencies, the most dramatic being the failure of Barings, a British bank, in 1995.

Trading activities, although often highly profitable, are dangerous because they make it easy for financial institutions and their employees to make huge bets quickly. Given the ability to place large bets, a trader, whether he or she trades in bond markets, in foreign exchange markets, or in financial derivatives, has an incentive to take on excessive risks: if his or her trading strategy leads to large profits, he or she is likely to receive a high salary and bonuses, but if he or she takes large losses, the financial institution will have to cover them.

To reduce this problem, managers of financial institutions must set up internal controls which among others include complete separation of the people in charge of trading activities from those in charge of the bookkeeping for trades.

U.S. regulators have become concerned about the increased risk that banks are facing from their off-balance-sheet activities, and are encouraging banks to pay increased attention to risk management.

6.6 Render the passage in English using the English equivalents of the italicized phrases given in Russian. Express the main idea of the passage in one sentence.

Баланс коммерческого банка можно *представить себе как* **(can be thought of)** перечень источников средств и использования этих средств. Обязательства банка – это его источники средств, которые

включают **(include)** текущие счета, срочные депозиты, ссуды из *Федеральной резервной системы* **(the Federal Reserve System),** заемы из других банков и корпораций, а также собственный капитал банка. Активы банка – это его использование средств, которое включает резервы, наличные средства *в процессе инкассо* **(in process of collection)**, депозиты в других банках, ценные бумаги, ссуды и *прочие* **(other)** активы.

Банки делают прибыль *посредством* **(through)** процесса трансформации активов: они *занимают средства на короткий период* **(borrow short)** - принимают депозиты, а затем *ссужают средства на долгий период* **(lend long)** – выдают ссуды. Когда банк *принимает дополнительные депозиты* **(takes in additional deposits)**, он получает *равное количество* **(an equal amount of)** резервов; когда банк *выплачивает* **(pays out)** депозиты, он теряет равное количество резервов.

Unit 6 Reading Self – Control Test
The Bank Balance Sheet

1. Which of the following is the main idea of the text?

(A) How banking works.
(B) Commercial banking.
(C) A bank’s financial reports.
(D) A bank’s intermediation services.

2. Judging by the economic background information in the text which you have familiarized yourself with the author is most likely to be

(A) an American
(B) a Russian
(C) a Japanese
(D) a Britisher

3. It can be derived from the text that the source of banks' profits is

(A) the increase of interest rate on their asset holdings of securities and loans over the interest and other expenses on their liabilities.

(B) the difference between the amount of banks' assets and the amount of their liabilities.

(C) the difference between the amount of banks' capital and the amount of their liabilities.

(D) the spread between the amounts of banks' deposits and assets.

4. It can be inferred from the text that a bank's liabilities are

(A) holdings of securities and certificates of deposit.

(B) its uses of funds.

(C) cash items in process of collection.

(D) its sources of funds.

5. Which deposit according to the information in the text is meant to be a transaction deposit?

(A) a certificate of deposit

(B) a savings deposit

(C) a negotiable order of withdrawal account

(D) a small-denomination time deposit

6. It can be derived from the text that non-transaction deposits are

(A) non-interest-bearing checking accounts.

(B) large-denomination time deposits.

(C) demand deposits.

(D) checkable deposits.

7. It can't be conferred from the text that Bank Capital is

(A) a cushion against insolvency.

(B) the net worth of a bank.

(C) the net assets of a bank.

(D) the bank's largest liability.

8. Which of the following statements would the author most probably agree with?

(A) Negotiable CDs are large-denomination time deposits.

(B) US banks are allowed to hold stocks.

(C) Eurodollars are U.S. banks' deposits denominated in the euro.

(D) Nonnegotiable CDs are typically held by corporations.

9. Which of the following statements would the author most probably disagree with?

(A) US banks are not allowed to hold stocks.

(B) Banks start listing their assets from the least liquid ones to cover short-term liabilities.

(C) Loans have a higher probability of default than other assets.

(D) Bank loans are the major source of banks' income.

10. What is most likely the subject of the extract which is missing from this text?

(A) correspondent banking

(B) a bank cash flow statement

(C) a bank's balanced portfolio of loans

(D) a bank's accounting procedures

Unit 6 Glossary

ACCOUNT: Account (in bookkeeping) refers to assets, liabilities, income, expenses, and equity, as represented by individual ledger pages, to which changes in value are chronologically recorded with debit and credit entries. These entries, referred to as postings, become part of a *book of final entry* or ledger. Examples of common financial accounts are cash, accounts receivable, mortgages, loans, common stock, sales, services, wages, and payroll.

ACCOUNTANTS: Practitioners of accounting.

ACCOUNTING: The system of recording, verifying, and reporting such financial information.

ACCOUNTING EQUATION: The 'basic accounting equation' is the foundation for the double-entry bookkeeping system. For each transaction, the total debits equal the total credits. Assets = Liabilities + Capital. In a corporation, capital represents the stockholders' equity.

ACCOUNTANTS: Practitioners of accounting.

ASSET: Something that you own. For a person, assets can be financial, like money, stocks, bonds, bank accounts, and government securities, or they can be physical things, like cars, boats, houses, clothes, food, and land. The important assets for our economy are the output we have produced and the resources, capital, and natural resources used to produce that output.

ASSET MANAGEMENT: The acquisition of assets that have a low rate of default and diversification of asset holdings to increase profits.

AUTOMATIC TRANSFER SERVICE ACCOUNTS: Deposit accounts offered by commercial banks, credit unions, savings and loan associations, and mutual savings banks that automatically transfer funds from interest-paying savings account to checking accounts when needed to process checks or to maintain minimum balances. Automatic transfer service (ATS) accounts effectively function as interest-paying checking accounts and are considered as one type of checkable deposits. Other checkable deposits are demand deposits (standard checking accounts), negotiable order of withdrawal (NOW) accounts, and share draft accounts.

BALANCE SHEET: A statement of the assets, liabilities, and net worth of a company at a given point in time. The basic relationship illustrated by a balanced sheet is that assets minus liabilities are equal to net worth. Or alternatively, assets are equal to liabilities plus net worth. This is one of two financial statements for an entity. The other is an income statement, which reports the revenues, expenses, and profit over a period of time.

BANK ASSETS: What a bank owns, including loans, reserves, investment securities, and physical assets. Bank assets are typically listed on the left-hand side of a bank's balance sheet. Bank liabilities, what a bank owes, are listed on the right-hand side of a bank's balance sheet. Net worth is the difference between assets and liabilities. The largest asset category of most banks is loans, which generates interest revenue. A critical asset category used to maintain the safety of deposits is reserves (vault cash and Federal Reserve deposits).

BANK BALANCE SHEET: A record of the assets, liabilities, and net worth of a bank at a given point in time. Assets are what a bank owns. Liabilities are what a bank owes. Net worth is the difference between the two and what is claimed by or owed to the owners of the bank. By definition, a balance sheet must balance. The assets on one side are equal to the liabilities and net worth on the other.

BANK FAILURE: In principle, this results when a bank's liabilities exceed assets for an extended period and the bank is forced to go out of business. This is comparable to other types of business that go bankrupt. However, because banks are heavily regulated by government entities, including the Federal Reserve System, Federal Deposit Insurance Corporation, and Comptroller of the Currency, bank failure does not necessarily mean that the bank ceases to operate. In many cases, such a failure means the operation of the bank is taken over by one of the government entities. The troubled bank might also be allowed or "encouraged" to merge with another, healthier bank.

BANK FOR INTERNATIONAL SETTLEMENTS: The Bank for International Settlements (BIS) is an international organization which fosters cooperation among central banks and other agencies in pursuit of monetary and financial stability. Established in 1930, the BIS is the world's oldest international financial organization. The head office is in Basel, Switzerland and there are two representative offices: in the Hong

Kong, China and in Mexico City. As its customers are central banks, the BIS cannot accept deposits from, or provide financial services to, private individuals or corporate entities.

BANK LIABILITIES: What a bank owes, including most notably customer deposits. Bank liabilities are typically listed on the right-hand side of a bank's balance sheet. Bank assets, what a bank owns, are listed on the left-hand side of a bank's balance sheet. Net worth is the difference between assets and liabilities. The most important liability category of most banks is checkable deposits, which is part of the economy's M1 money supply. The largest liability category includes other types of deposits (especially savings deposits, certificates of deposit, and money market deposits) that enter into the M2 and M3 monetary aggregates.

BANK PANIC: Economy-wide concern over the stability of the banking system prompted by the failure of a few banks, which then contributes to the failure of many more banks, which contributes to the failure of even more banks, in a snowballing effect.

BANK RESERVES: The "money" that banks use to conduct day-to-day business, including cashing checks, satisfying customers' withdrawals, and clearing checks between accounts at different banks. The "money" in question includes vault cash and Federal Reserve deposits. Specifically, vault cash is the paper money and coins that a bank keeps on the bank premises (both in the vault and in teller drawers), which is used to "cash" checks and otherwise provide the funds that customers withdraw. Federal Reserve deposits are accounts that banks keep with the Federal Reserve System, which are used to process, in a systematic, centralized fashion, the millions of checks written each day by customers of one bank that are deposited by customers of another bank. Using these deposits, the Fed acts as a central clearing house for checks, being able to simultaneously debit the account of one bank and credit the account of another. More on the importance of bank reserves can be found under fractional-reserve banking.

BANK RUN: A situation in which a relatively large number of a bank's customers attempt to withdraw their deposits in a relatively short period of time, usually within a day or two. While common throughout the 1800s and early 1900s, government deposit insurance has largely eliminated banks runs in the modern economy. Historically a bank run

was prompted by fears that the bank was on the verge of collapse, causing deposits to become worthless. Ironically a bank run often caused the bank to fail. Bank runs were often infectious, leading to economy-wide bank panics and business-cycle contractions.

BANK: A financial organization that accepts deposits, makes loans, and directly controls a significant portion of the nation's money supply. In the olden days of the economy (before 1980), a bank was easy to identify because it had the word "bank" in its name -- such as "First National Bank", "Second National Bank", etc. However, after several laws were passed in the early 1980s to reform and deregulate the banking industry, the term bank has come to functionally include other financial institutions that previously went by the titles of "Savings and Loan," "Credit Union," and "Mutual Savings Banks." These institutions are operationally considered banks because they all perform "banking" functions -- especially accepting checking account deposits and making loans.

BANK CAPITAL: The difference between the value of a bank's assets and its liabilities. The bank capital represents the net worth of the bank or its value to investors.

BANKING: The industry consisting of financial intermediaries that maintain deposits (that is, the industry of banks). Banking is one of several financial industries, with insurance and stock trading two other notable examples. Firms that comprise the banking industry are traditional banks, savings and loan associations, credit unions, and mutual savings banks. Banking in modern economies is generally fractional-reserve banking, with banks acting as financial intermediaries and keepers of deposits.

BANKRUPTCY: A legal declaration that the liabilities of a proprietor (individual), partnership, or corporation are greater than assets. In other words, a consumer or business that is unable to pay the bills can go to court and be formally declared bankrupt. The impetus for entering a court can come voluntarily from the deadbeat who has acquired more liabilities than assets, or involuntarily from the creditors who have been unable to collect from the deadbeat. All of the debtor's assets are measured and evaluated, whereupon the assets are used to repay a

portion of outstanding debt. Upon the successful completion of bankruptcy proceedings, the debtor is relieved of the debt obligations incurred prior to filing for bankruptcy. Bankruptcy offers an individual or business a chance to start fresh by forgiving debts that simply can't be paid while offering creditors a chance to obtain some measure of repayment based on what assets are available.

BARING'S BANK: (1762 to 1995) was the oldest merchant bank in London until its collapse in 1995 after one of the bank's employees, Nick Leeson, lost £827 million ($1.3 billion) speculating—primarily—on futures contracts. Barings was founded in 1762 by Sir Francis Baring to as "John and Francis Baring Company. In 1803, it has helped finance the Louisiana Purchase by United States to France. In 1806, the son of Francis Alexander Baring joined the firm they renamed it Baring Brothers & Co., after its merger with the London office of the Dutch bank "Hope & Co. ", where Alexander worked with Henry Hope. In 1890, the bank found itself facing serious difficulties because of its exposure to the first default a sovereign debt that the Argentina and the Uruguay. She was rescued by a consortium organized by the governor of the Bank of England, William Lidderdale, during the crisis of 1890. Since the king George V, it was also the bank of the British Royal Family until his death February 26, 1995, when she was taken by ING at the symbolic price of one Pound.

BEARER INSTRUMENT: A security payable to the holder or "bearer" when presented. No proof of ownership is required.

CASH: the common term for paper currency and metal coins components of the money supply. Cash includes the foldable green paper with portraits of famous dead people, and those shiny metal discs with raised imprints of famous dead people. Cash is often divided into the "cash in circulation" which is what the nonbank public uses for purchases, and "vault cash" which is what banks have stashed away in the large, highly-secured, vaults. Cash in circulation is part of the money supply. Vault cash is part of bank reserves.

CASH ITEMS: Any check given immediate credit to a customer's account, before a bank has received payment from the paying bank.

CD: The abbreviation for certificate of deposit, which is a type of savings account maintained by banks and other depository institutions that pays higher interest rates that normal savings accounts, but requires the funds not be withdrawn for a specified time period. Small denomination CDs (under $100,000) are a component of the M2 monetary aggregate. Larger denomination CDs (over $100,000) are a component of the M3 monetary aggregate.

CHECK CLEARING: The process in which reserves or funds are transferred among banks to settle the accounts of checks written on one account and deposited into another. Check clearing is the heart and sole of daily banking activity and the final step in the use of checkable deposits as the medium of exchange for conducting transactions in the economy. Check clearing is facilitated by central clearinghouses, including the Federal Reserve System and a number of private organizations. The check clearing process is also a key component of the money creation process.

CHECKABLE DEPOSIT: A checking account deposit maintained by a bank, savings and loan association, credit union, or mutual savings bank. These accounts, also termed transactions deposits, let customers transfer funds easily and quickly to another person, which makes them ideally suited for use as money. Checkable deposits are typically between 60 and 70 percent of the M1 money supply.

COLLECTION: The conversion of accounts receivable into cash.

COMMERCIAL LOAN: A debt-based funding arrangement that a business can set up with a financial institution. The proceeds of commercial loans may be used to fund large capital expenditures and/or operations that a business may otherwise be unable to afford.

CONSUMER LOAN: Money loaned to individuals (usually on nonsecured basis for personal, family, or household purposes; as opposed to business or commercial lending. Consumer loans are monitored by government regulatory agencies for their compliance with consumer protection regulations such as the ‘truth in lending’ law. Also called consumer credit or consumer lending.

CORRESPONDENT BANK: A financial institution that provides services on behalf of another, equal or unequal, financial institution. A

correspondent bank can conduct business transactions, accept deposits and gather documents on behalf of the other financial institution. Correspondent banks are more likely to be used to conduct business in foreign countries, and act as a domestic bank's agent abroad. Correspondent banks are used by domestic banks in order to service transactions originating in foreign countries, and act as a domestic bank's agent abroad. This is done because the domestic bank may have limited access to foreign financial markets, and cannot service its client accounts without opening up a branch in another country.

DEFAULT: A situation in which the party issuing a debt instrument is unable to make interest payments or pay off the amount owed when the instrument matures.

DEFAULT RISK: The probability that a borrowing agent will not pay in full the agreed interest and/or principal. A default risk can be assigned to any bond or loan agreement. Of course, there are some instruments considered default-risk-free, that is, instruments for which the probability that a borrowing agent will not pay is zero. The most noted examples are the U.S. Treasury securities, which have virtually no default risk because the U.S. government guarantees that all the principal and interest will be repaid. When calculating the risk premium on financial instruments, investors use default-risk-free instruments for comparison.

DEMAND DEPOSIT: A bank deposit that can be withdraw "on demand." This is a once common, but increasingly dated term meaning checking account deposits, checkable deposits, or transactions deposits. To the extent that demand deposits is the term used to mean checkable deposits, they are an important part of the M1 money supply. The term "demand" was used to distinguish checkable deposits from savings deposits in which accessed could be delayed for a period of "time," and not on "demand." Hence the complementary term for savings deposits is time deposits.

DEPOSIT: A bank account maintained by a bank on behalf of a customer. In a fractional-reserve banking system, one of the primary functions of a bank is to keep customer deposits safe. Banks offer a wide range of deposits, including checkable (or transactions) deposits, savings deposits, certificates of deposit, and money market accounts. Such

deposits represent a sizable portion of the M1 money supply and as well as broader monetary aggregates -- M2 and M3. They also constitute the bulk of the liabilities of a typically bank.

DISCOUNT RATE: The interest rate that the Federal Reserve System charges for loans to banks. To ensure that our nation's banks retain their liquidity and remain in business, the Federal Reserve System stands ready to lend bank reserves on a moment's notice to any bank. The discount rate is the interest rate the Federal Reserve System charges for these loans. Like any interest rate, when it goes up (or down) it discourages (or encourages) borrowing. In principle, the Fed can use the discount rate to control our nation's money supply.

FEDERAL FUNDS MARKET: The market used by banks to borrow and lend bank reserves. In particular, a substantial part of the reserves held by banks are deposits with the Federal Reserve System. On many occasions some banks will have more deposits than they need to meet the Fed's reserve requirements, while other banks find themselves a little short. It's a simple matter then for one bank to lend some of these extra reserves to another--usually for no more than a few days. Working on instructions from the banks, the Fed electronically switches funds from one account to another and a federal funds market loan has been completed. The interest rate tacked on by the lending bank is termed the federal funds rate.

FEDERAL FUNDS RATE: The interest rate that banks charge each other when loaning bank reserves through the federal funds market. This is a key interest rate in the economy because helps to determine banks' minimum cost of getting funds. If the federal funds rate is higher, then banks are likely to raise the interest rates they charge, like the prime rate, home mortgage rate, or rate on car loans.

FEDERAL FUNDS: Deposits that banks keep with the Federal Reserve System. These deposits are important for bank stability, clearing checks between banks, money creation, and money supply control. They are also borrowed and loaned between banks through the federal funds market. The interest charged for these loans is the Federal Fund rate.

FEDERAL RESERVE DEPOSITS: Deposits that commercial banks keep with the Federal Reserve System. Federal Reserve deposits, together with vault cash are the bank reserves that banks use to back up

customers' deposits and otherwise conduct daily transactions, such as processing checks and satisfying customers cash withdrawals. Federal Reserve deposits play three key roles in the banking system. One, they are used by the Federal Reserve system to process of clear checks. Two, they are loaned between commercial banks through the federal funds market. Three, they are used by the Federal Reserve System to control the money supply.

FINANCIAL DERIVATIVES: In finance, a derivative is a financial instrument (or, more simply, an agreement between two parties) that has a value, based on the expected future price movements of the asset to which it is linked—called the underlying asset—such as a share or a currency. There are many kinds of derivatives, with the most common being swaps, futures, and options. Derivatives are a form of alternative investment.

FOREIGN EXCHANGE MARKET: A market that trades foreign exchange. The currencies of the advanced nations, and many of the lesser developed ones, are at the top of what's traded in this market. The price at which one currency is traded for another in this market is the exchange rate. Like many "markets" this one is not located at any particular place, but includes transactions around the globe. As you might expect, banks handle a lot of these transactions.

FUTURES: An agreement to complete the sale of a commodity at a pre-determined price on some future date. Much of the real stuff that consumers buy is what is usually termed a spot transactions. You buy the stuff, pay the price, and take it home with you. While financial markets have a substantial number of these spot transactions they are also heavily into futures transactions. A financial contract obligating the buyer to purchase an asset (or the seller to sell an asset), such as a physical commodity or a financial instrument, at a predetermined future date and price. Futures contracts detail the quality and quantity of the underlying asset; they are standardized to facilitate trading on a futures exchange. Some futures contracts may call for physical delivery of the asset, while others are settled in cash. The futures markets are characterized by the ability to use very high leverage relative to stock markets. Futures can be used either to hedge or to speculate on the price movement of the underlying asset. For example, a producer of corn could use futures to lock in a certain price and reduce risk (hedge). On

the other hand, anybody could speculate on the price movement of corn by going long or short using futures.

GOVERNMENT SECURITY: A financial instrument used by the federal government to borrow money. Government securities are issued by the U.S. Treasury to cover the federal government's budget deficit. Much like consumers who borrow money from banks to finance the purchase of a house or car, the federal government borrows money to finance some of its expenditures. These securities include small denomination ($25, $50, or $100), nonnegotiable Series EE savings bonds purchased by consumers. The really serious money, however, is borrowed using larger denomination securities ($100,000 or more) purchased by banks, corporations, foreign governments, and others with large sums of money to lend.

HEDGING: Buying or selling futures contracts to protect against price changes. This is a common form of "insurance" used by those who produce various commodities, such as wheat, cattle, coffee, and natural gas, as well as those who buy these commodities as inputs.

HOLDING COMPANY: A company (usually a corporation) that owns enough stock in another corporation to exercise virtually complete control over its management. Holding companies often own controlling interest in several diverse corporations, allowing it to engage in diverse activities (some of which might be risky) while limiting its liability should problems arise. While holding companies exist in most types of industries, then tend to be quite popular in banking. Through a holding company, a bank can essentially take part in other financial markets (selling insurance, underwriting securities, or acting as a broker) that are beyond the legal authority of the bank itself.

INCENTIVE: A cost or benefit that motivates a decision or action by consumers, businesses, or other participants in the economy. Some incentives are explicitly created by government policies to achieve a desired end or they can just be part of the wacky world we call economics. The most noted incentive in the study of economics is that provided by prices. When prices are higher buyers have the "incentive" to buy less and sellers have the "incentive" to sell more. Price incentives play a fundamental role. When prices are higher buyers have the "incentive" to buy less and sellers have the "incentive" to sell more. Price incentives play a fundamental role in the allocation. When prices

are higher buyers have the "incentive" to buy less and sellers have the "incentive" to sell more. Price incentives play a fundamental role in the allocation system that society uses to answer the three questions of allocation.

INDUSTRIAL LOAN: Industrial loans are secured loans offered and availed commonly to, by manufacturers and industrialists. When talking about industrial loan, most common borrowers are small, medium to large industries. Industrial loans are for the purpose of financing the purchase of additional plants and machineries that can be used for production of goods or acquisition of service. An industrial loan is sometimes mistaken to business loans. Actually industrial loans are like business loans but with a larger scale or larger scope. Industrial loans are long term in nature. It gives manufacturers enough time to regain their investments and eventually repay. And like any other loans, industrial loans repayment method is on equal amortization basis. Industrial loans factor of approval depends on many causes.

INSOLVENT: A situation in which the value of a firm's or bank's assets have fallen below its liabilities; bankrupt.

INSOLVENCY: When an individual or organization can no longer meet its financial obligations with its lender or lenders as debts become due. Insolvency can lead to insolvency proceedings, in which legal action will be taken against the insolvent entity, and assets may be liquidated to pay off outstanding debts.

INTERBANK LOAN: A loan made from one bank to another.

INTERNAL CONTROL: In accounting and auditing, internal control is defined as a process effected by an organization's structure, work and authority flows, people and management information systems, designed to help the organization accomplish specific goals or objectives. It is a means by which an organization's resources are directed, monitored, and measured. It plays an important role in preventing and detecting fraud and protecting the organization's resources

LIABILITY: An obligation that legally binds an individual or company to settle a debt. When one is liable for a debt, they are responsible for paying the debt or settling a wrongful act they may have committed. For example, if John hits Jane's car, John is liable for the damages to Jane's

vehicle because John is responsible for the damages. In the case of a company, a liability is recorded on the balance sheet and can include accounts payable, taxes, wages, accrued expenses, and deferred revenues. Current liabilities are debts payable within one year, while long-term liabilities are debts payable over a longer period.

LIABILITY MANAGEMENT: The acquisition of funds at low cost to increase profits.

LIQUIDATION: The act or process of liquidating; the state of being liquidated. When a business or firm is terminated or bankrupt, its assets are sold and the proceeds pay creditors. Any leftovers are distributed to shareholders.

LIQUIDITY: The ease of converting an asset into money (either checking accounts or currency) in a timely fashion with little or no loss in value. Money is the standard for liquidity because it is, well, money and no conversion is needed. Other assets, both financial and physical have varying degrees of liquidity. Savings accounts, certificates of deposit, and money market accounts are highly liquid. Stocks, bonds, and are another step down in liquidity. While they can be "cashed in," price fluctuations, brokerage fees, and assorted transactions expenses tend to reduce their money value. Physical assets, like houses, cars, furniture, clothing, food, and the like have substantially less liquidity.

LIQUIDITY MANAGEMENT: The decision made by a bank to maintain sufficient liquid assets to meet the bank's obligations to depositors.

LOAN: In general, a transaction in which a legal claim is exchanged for money. The legal claim is typically a contract or promissory note stipulating when and how the money will be repaid. The lender gives up the money and receives the legal claim. The borrower gives up the legal claim and receives the money. A loan can be either an asset or a liability, depending on who does the borrowing and who does the lending. To the borrower, a loan is a liability, something that is owed. The borrower must pay off the loan or repurchase the legal claim. However, to the lender, a loan is an asset, something that is owned. In fact, loans represent a significant part of a bank's assets.

LOAN LOSS RESERVES: A special account set aside by banks acting as a buffer between deposits and net worth that's used in case a loan is

not repaid. Without this reserve, an unpaid loan on the asset side of a bank's balance sheet would require an adjustment of deposits or net worth on the liability side. The loan loss reserve is used for this adjustment.

LOAN SALE: The sale under a contract (also called a secondary loan participation) of all or part of the cash stream from a specific loan, thereby removing the loan from the bank's balance sheet.

MATURITY: That date at which the principal on a bond or similar financial asset needs to be repaid. Maturity dates can be anywhere from a few hours to 30 or more years. For example, government securities are classified by their maturity dates, with Treasury bills maturing in one year or less, Treasury notes in 1 to 10 years, and Treasury bonds in 10 years or more. Under normal (nonrecessionary) conditions, shorter maturity periods carry lower interest rates, while longer maturities need higher interest rates to compensate for the uncertainty of tying funds up for longer periods.

NEGOTIABLE ORDER OF WITHDRAWAL ACCOUNTS: Interest-paying checking accounts maintained by commercial banks, savings and loan associations, and mutual savings banks. These function much like standard demand deposit checking accounts in that the funds can be withdrawn "on demand" by writing a check, but an interest is paid on the outstanding balance. Negotiable order of withdrawal (NOW) accounts are one type of checkable deposits. Others are demand deposits (standard checking accounts), share draft accounts, and automatic transfer service (ATS) accounts.

NEGOTIABLE CERTIFICATES OF DEPOSIT: A bank-issued short-term security that is traded and documents a deposit and specifies the interest rate and the maturity date.

NEGOTIABLE INSTRUMENT: A document guaranteeing the payment of a specific amount of money, either on demand, or at a set time. According to the Negotiable Instruments Act, 1881 there are just three types of negotiable instruments i.e., promissory note, bill of exchange and check.

NONNEGOTIABLE INSTRUMENT: Document of title (such as an air waybill) or a financial instrument (such as a crossed

check) that may not be transferred from the holder or named party to another.

OFF-BALANCE-SHEET ACTIVITIES: Bank activities that involve trading financial instruments and the generation of income from fees and loan sales, all of which affect bank profits but are not visible on bank balance sheets.

OPTION: A financial derivative that represents a contract sold by one party (option writer) to another party (option holder). The contract offers the buyer the right, but not the obligation, to buy (call) or sell (put) a security or other financial asset at an agreed-upon price (the strike price) during a certain period of time or on a specific date (exercise date). Call options give the option to buy at certain price, so the buyer would want the stock to go up.
Put options give the option to sell at a certain price, so the buyer would want the stock to go down.

OVERNIGHT CASH RATE: The interest rate for very short-term interbank loans.

PHYSICAL ASSET: A productive resource, capital, property, or satisfaction-generating good. Also termed real asset. This should be contrasted with financial assets that are legal claims on physical assets.

RATE OF RETURN: The ratio of the additional annual income or profit generated by an investment to the cost of the investment. Here's a simple example, although the calculations are usually a great deal more involved for actual investments. If the cost of constructing a new factory is $10 million and it gives you an extra $1 million in profit each year, then its rate of return is 10 percent.

REGULATION: Government rules or laws that control the activities of businesses and consumers. The motivation for regulation is that businesses are inclined to do things that are harmful to the public--actions which need to be prevented or otherwise controlled. Regulation is essentially an extension of government's authority to protect one member of society from another. It tends to take one of two forms--(1) industry regulation that's intended to prevent firms from gaining and abusing excessive market control and (2) social regulation that seeks to protect consumers for problems caused by pollution, unsafe products, and the lack of information (market failure).

REGULATOR: Regulator (economics), an agency established by central government for the control of or intervention in the operation of markets

REPURCHASE AGREEMENT: A common type of bank account in which funds are transferred from one account to another, then automatically transferred back after a short period, usually overnight. In effect, a bank customer buys a legal claim from a bank with the understanding that the bank will automatically "repurchase" this legal claim back after a specified time period. Repurchase agreements were originally developed as a roundabout means of paying interest on business checking, when such interest paying was legally prohibited. Repurchase agreements are near monies added to M1 to obtain broader monetary aggregates, M2 and M3.

REPURCHASE AGREEMENT: A form of a loan in which the borrower simultaneously contracts to sell securities and contracts to repurchase them, either on demand or on a specified date.

REQUIRED RESERVES: The amount of vault cash and/or Federal Reserve deposits that a bank must legally keep to back outstanding deposits. These are the assets that bank regulators specify a bank must have to ensure the stability of deposits and conduct daily transactions.

RESERVE RATIO: The amount of reserves required by the Federal Reserve System as a ratio of the amount deposits backed by the reserves. Modern reserve ratios are in the range of 1-3% for checkable deposits. The reserve ratio plays a key role in the deposit multiplier. The simple deposit multiplier is simply the inverse of the reserve ratio. If the reserve ratio is 5%, then the deposit multiplier is 20. It's just that simple.

RESERVE REQUIREMENTS: Rules by the Federal Reserve System governing the amount of bank reserves that banks must keep to back up their deposits. Legal reserve requirements came about because banks that practice fractional-reserve banking are sometimes inclined to make too many interest-paying loans and neglect to keep enough reserves on hand to pay their depositors. In principle, the Fed can alter reserve requirements to control the money supply. In practice, however, the Fed prefers to use open market operations or the discount rate.

RESERVES: The vault cash and deposits at the Federal Reserve System that banks use to complete day-to-day transactions. Banks' holding of

deposits in accounts with the Fed, plus currency that is physically held by banks (vault cash).

RISK: The possibility of gain or loss. Risk the calculated probability of different events happening, is usually contrasted with uncertainty the possibility that any number of things could happen. For example, uncertainty is the possibility that you could win or lose $100 on the flip of a coin. You don't know which will happen, it could go either way. Risk, in contrast, is the 50 percent chance of winning $100 and the 50 percent chance of losing $100 on the flip of the coin. You know (or think you know) that your probability of winning or losing is 50 percent because the coin has a 50 percent chance of coming up either heads or tails.

SAVINGS ACCOUNTS (SAVINGS DEPOSITS): Accounts maintained by banks, savings and loan associations, credit unions, and mutual savings banks that pay interest but cannot be used directly as money. These accounts, also termed transactions deposits, let customers set aside a portion of their liquid assets that COULD be used to make purchases. But to make those purchases, savings account balances must be transferred to checkable deposits or currency. However, this transference is easy enough that savings accounts are often termed near money. Savings accounts, as such constitute a sizeable portion of the M2 monetary aggregate.

SHARE-DRAFT ACCOUNT: Share-draft accounts were created under the Consumer Checking Account Equity Act of 1980. They allow credit-union members to access their share balances by writing drafts on their accounts. Share-draft accounts allow for an unlimited number of checks to be written, and one of their primary benefits is that they are secured with federal insurance. Interest earned on share-draft accounts is compounded quarterly. These accounts are similar to negotiable order of withdrawal (NOW) accounts, which are basically interest-bearing savings accounts against which drafts can be written. However, share-draft accounts are offered by credit unions, whereas NOW accounts are bank products.

SOLVENT: Capable of meeting financial obligations.

SOLVENCY: In finance or business, is the degree to which the current assets of an individual or entity exceed the current liabilities of that individual or entity. Solvency can also be described as the ability of a corporation to meet its long-term fixed expenses and to accomplish long-term expansion and growth. This is best measured using the net liquid balance (NLB) formula. In this formula solvency is calculated by adding cash and cash equivalents to short-term investments, then subtracting notes payable.

SPECULATION: Buying an asset with the intent of reselling it later at a higher price. The purpose of speculation is simply to buy low today and sell high tomorrow. Those who engage in speculation have no reason for buying the asset, other than resale at a later time. Such speculation is quite common in most financial markets (futures markets are a particular favorite), but it's also a motive for those who have "investments" in fine art, baseball cards, coins, and real estate.

SWAP: A financial contract that obligates one party to exchange a set of payments it owns for a set of payments owned by another party.

T-ACCOUNT: A handy little diagram used to illustrate changes in the assets and liabilities of a bank's balance sheet. A T-account, so named because or its perpendicular lines that look like a T, represents changes in assets on the left and changes in liabilities and net worth on the right.

TIME DEPOSITS: Interest-paying bank accounts maintained by traditional commercial banks, credit unions, savings and loan associations, and mutual savings banks with a minimum time (at least seven days) before deposited funds can be withdrawn. Time deposits come in one of two varieties: (1) savings deposits and (2) certificates of deposit. The minimum time period prevents these accounts from functioning as demand deposits and being widely used as money. Time deposits, along with money market mutual funds, are added to M1 to derive M2.

VAULT CASH: Paper currency and metal coins possessed by a commercial bank, either stored in the actual bank vault or temporarily resting teller drawers. Vault cash is primarily used to facilitate daily bank transactions (that is, cashing checks), and together with Federal Reserve deposits make up legal bank reserves.