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Banks Making Money

Basically, banks derive profits from the interests on loans made to borrowers, using the deposits from customers receiving lower interest rates. For example, when a customer deposits $100 and the bank promises a return of 5%, then that customer would receive $105 at the end of the term. The bank can then loan the $100 to a borrower who promises to repay at an interest rate of 15%, (or $115); thus, the bank profits by $10. Banks perform these transactions multiple times amassing trillions of dollars in profits.

Primarily, banks offer two different types of accounts**: Savings and Checking**. Each type has variations such as CDs, Money Markets, Credit Cards, Mortgages, etc.

You must be eighteen or older to open a banking account--eighteen is the minimum age where you may legally enter into agreements. However, with parents (or legal guardians) cosigning the agreement you may be as young as 13 to legally own an account.

Banks are closely regulated by federal and state guidelines. These guidelines protect the consumer from fraudulent banking practices such as loans that exceed a bank's assets (deposits, land titles, stocks, and bonds)--often called insolvency.

Often, consumers with poor credit ratings--who cannot secure loans from banks turn to lenders who are less regulated--like "payday" loan services. These types of lenders prey upon the high risk borrower by requiring them to pay much higher interest rates, and to provide collateral such as car titles, and property deeds to guarantee the loan. If a borrower defaults on loans issued by "payday" lenders they likely lose their property--and can even be evicted or foreclosed from their home.

Wealthy consumers, corporations, and even countries participate in another type of banking , better known as investment banking. There are no depositors in investment banking. Raising capital for issuing securities (generally stocks and bonds) for corporations is the primary activity for investment banking. Investment bankers also provide vital information to corporations seeking mergers and acquisitions. Investment banking can be a very lucrative career, but the success depends largely on how good the advice and information provided is. One misstep can lead to ruin for investment banks--such was the case for Goldman Sachs in 2008. Goldman Sachs investment banking had to rescued ("bail out") by the federal government because of the collapse in the subprime (buying low, and hoping to sell high) lending market.

In addition to regular "passbook" savings accounts, banks offer consumers Certificate of Deposit (CDs), Money Market, Individual Retirement Accounts (IRAs), and other kinds of savings instruments to attract depositors. The success of any bank depends largely on attracting and retaining depositors to have funds available for making loans and investments. Should banks lose deposits their ability to make loans erodes, which could lead to the failure of the bank. When economic trends lead to widespread bank failures then entire financial markets (both domestic and global) may collapse--like in 1929 when the collapse triggered what is known as the start of the "Great Depression" era of the 1930s.

Checking accounts provide consumers with the ability to pay for goods and services by drawing funds from their account. When an account is overdrawn (i.e. when the amount on a written check exceeds the balance of the account) the bank will assess a penalty fee and will not cover the transaction. The account owner will incur a "double whammy" and, must not only repay the vendor, but also pay the bank fee for overdrawing the account. Repeated attempts at overdrawing an account can lead the bank to alert authorities-- who may then charge the account owner with violating banking laws, leading to prosecution and possible incarceration -- Jail Time!

Interest rates are established by banks based upon the rates they have to pay when they borrow funds. Banks borrow funds to maintain a required level of deposits to loans. When bank loans rise too high the bank must borrow from other banks (or from the Federal Reserve Bank) to get back in the required deposits to loans ratio. The interest rates banks charge each other is negotiated between the two banks and the average of all the rates used is known as the Federal Funds rate. This rate establishes what is commonly called the Prime Interest Rate, and is usually 3 percent higher than the Federal Funds rate.