

THE FED TODAY

History, Structure, Monetary Policy, Banking Supervision, Financial Services, and More!

LESSON SIX:

THE FED-HELPING KEEP BANKS SAFE AND SOUND

LESSON OVERVIEW:

Students will recall from the historical section of *The Fed Today* video how bank panics in the past threatened the entire banking system and the health of the United States economy. This lesson focuses on why banks have to be supervised and regulated in order to avoid the bank runs and financial instability of the past. Students will discuss how banks are in business to make money by offering customers a range of products. They will discover also that banks have a responsibility to customers and to the community at large to operate in a sound manner. The Federal Reserve has a supervisory role along with other state and federal regulators to keep banks safe and sound.

In this lesson students will review the products that banks provide to consumers and learn how banks make a profit. Students will also play the role of a bank examiner and evaluate a six-month-old loan made to the hypothetical owner of a mystery bookstore.

Students use a bank examiner's tool known as the "Five-Cs" (capital, capacity, collateral, condition, and character) to evaluate and grade the loan.

STUDENT OBJECTIVES:

Students will:

- List at least three ways a bank attempts to earn a profit.
- Describe why unhealthy banks can create a risk to the financial system.
- Identify methods used to evaluate the stability of a bank.
- Be able to explain why banks must be responsible to consumers and the community.
- Demonstrate how a bank examiner reviews an existing loan by using a tool called the 5-Cs.

TIME NEEDED:

One-two 50-minute class period

MATERIALS:

- Classroom Visual: *The Business of Banking*
- Student Handout: *Examining a Virtual Bank* (based on a web-based activity at <http://www.kc.frb.org/fed101/supervision/bankexam.cfm/>)
- Access to the FED101 website: <http://www.kc.frb.org/fed101/supervision/> to learn more about bank supervision and regulation and consumer protection legislation. On-line quiz available. (Optional)

TEACHER PREPARATION:

1. Review Classroom Visual: *The Business of Banking*.
2. Review Student Handout: *Examining a Virtual Bank* (based on an existing web-based activity at <http://www.kc.frb.org/fed101/supervision/bankexam.cfm/>).
3. Review the FED101 website: <http://www.kc.frb.org/fed101/supervision/> to learn more about bank supervision and regulation and consumer protection legislation, and take an on-line quiz.

ACTIVITY:

Understanding the Fed's Role in the U.S. Banking System

PROCEDURES:

1. Explain that a safe and sound banking industry is essential for a healthy economy. Ask students to recall the history section of *The Fed Today* video when the U.S. was plagued by financial instability. Explain to students that many of the money and banking problems in the 1800s occurred because of insufficient supervision and regulation of the banking industry.
2. Project Classroom Visual: *The Business of Banking*. (As the teacher explains each section, remaining sections on the overhead slide should be covered up.)
3. Ask students how banks make money and about the kinds of products they offer to consumers (for example, savings and checking accounts, business and residential loans, and credit card loans). Ask students to identify some of the other ways banks make money (by charging fees on ATM transactions, making commissions on stock purchases, and selling other financial products).
4. Ask students what they think the term “safe and sound” means when used in the context of bank regulation. Ask what they think bank examiners look for when they examine a bank. Explain that a bank’s financial condition depends on the quality of its **Capital, Assets, Management, Earnings, Liquidity,** and **Sensitivity** to risk (a rating system called “CAMELS”).
5. Ask students what kind of responsibility banks have to consumers and the community (to provide clear information about services and lending products, and equal and fair access to credit to all individuals and all segments of the community).
6. Divide students into five groups, providing each group with Student Handout: *Examining a Virtual Bank* (based on an existing web-based activity at <http://www.kc.frb.org/fed101/supervision/bankexam.cfm/>). Explain that one of the bank examiner’s duties is to identify potential risks to a bank. One type of risk is a bad loan, or a loan that is unlikely to be repaid by a borrower.
7. Discuss the examination tool called the “5-Cs” on the Student Handout: *Examining a Virtual Bank*. Go over the financial scenario with the students, checking for understanding along the way. Each group should analyze the loan using the 5-Cs just as a bank examiner would. For each “C” they should rate the loan good, adequate, or poor.
8. Ask members of each group to vote on whether they think this loan can be rated as pass, sub-standard, doubtful, or loss. Poll each student group for its recommendation. Share the information from the Student Handout Answer Key with the class. Emphasize that in a real bank examination there would be many more loans to rate and other duties to perform, such as gathering financial information and checking for compliance with consumer protection laws.
9. **Teacher Summary:** Explain to students that along with other state and federal agencies, the Federal Reserve plays an important role in supervising and regulating banks. Ask for student participation to summarize the following main points:
 - Bank regulation is important in maintaining safety and soundness of the banking system. An unhealthy banking system is a barrier to a healthy economy.
 - Bank examiners review two areas of a bank’s operations: financial condition and compliance with bank regulations.
 - Banks have a responsibility to provide consumers and communities with clear information about lending terms and equal access to credit regardless of race, religion, or income level.

EXTENDING THE LESSON:

Have students visit the FED101 website at: <http://www.kc.frb.org/fed101/supervision/> to learn more about bank supervision and regulation and consumer protection legislation, and take an on-line quiz.

DISCUSSION POINT:

Myth:

The Fed is not a good supervisor of banks because it allows banks to keep only a fraction of their deposits on hand.

REALITY:

The fact that banks are required to keep on hand only a fraction of the funds deposited with them is a function of the banking business. Banks borrow funds from their depositors (those with savings) and in turn lend those funds to the banks' borrowers (those in need of funds). Banks make money by charging borrowers more for a loan (a higher percentage interest rate) than is paid to depositors for use of their money. If banks did not lend out their available funds after meeting their reserve requirements, depositors might have to pay banks to provide safekeeping services for their money.

For the economy and banking system as a whole, the practice of keeping only a fraction of deposits on hand has an important cumulative effect. Referred to as the fractional reserve system, it permits the banking system to "create" money.

THE BUSINESS OF BANKING

Banks Are Businesses

- When customers deposit money in a bank account, they have a safe place to store their money and may receive interest on their deposit.
- Banks are only required to keep a percentage of deposits on reserve as cash. They lend the rest to qualified borrowers.
- Borrowers who wish to buy a house or a new car are charged interest on their loans. That interest is the banks' primary source of income.
- Banks also make money from charging fees for other financial services, such as debit cards, automated teller machine (ATM) usage, and checking accounts.

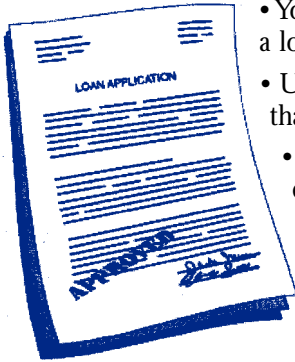
Safe and Sound Banks

- Many of the money and banking problems that occurred during the 1800s arose because of insufficient supervision and regulation of the banking industry.
- Federal Reserve Bank examiners, along with other state and federal regulators, review banks' regularly submitted financial reports and conduct on-site bank examinations.
- Banks are rated based on their financial condition and how well they comply with banking regulations.
- A bank's rating depends on the quality of its Capital, Assets, Management, Earnings, Liquidity, and Sensitivity to risk (a rating system called "CAMELS").

Banks Have a Responsibility to Consumers and Communities

- Banks are required to provide accurate information about their services. For example, information about terms, interest rates, and fees must be made clearly available to borrowers.
- Banks are required to provide equal access to credit regardless of race, sex, or religion.
- Banks are required to meet the needs of entire communities, including low-to-moderate-income areas.

EXAMINING A VIRTUAL BANK



- You are an examiner on the team at ABC Bank, and you have been assigned to review a loan, which is a standard step in a bank examination.
- Using the 5-Cs, analyze the quality of the loan and the borrower, and the likelihood that the loan will be paid back.
- For each “C,” rate the loan Good, Adequate, or Poor. You will learn about the experts’ rating after your selection.
- After rating the 5-Cs, classify the loan as Pass, Substandard, Doubtful, or Loss.

THE 5-Cs

Capacity:	Capacity measures the borrower’s ability to pay, including the borrower’s payment source, such as a job, or profits from a business, and amount of income relative to amount of debt.
Collateral:	Collateral helps determine a bank’s options if the loan is not repaid. What asset is pledged as collateral? What is its market value? Can it be sold easily? A valuable asset could include a house or a car.
Condition:	Condition refers to the borrower’s circumstances. For example, if a furniture store owner asked for a loan, the banker would be interested in how many chairs and sofas he or she expected to sell over the next few years.
Capital:	Capital consists of the applicant’s assets (house, car, savings) minus liabilities (home mortgage, credit card balance). If applicants have more liabilities than assets, they could have difficulty repaying their loans if their regular sources of income unexpectedly decreased.
Character:	Character measures the borrower’s willingness to pay. This is gauged by reviewing the borrower’s payment history, credit report, and information from other lenders.

LOAN INFORMATION

Judy Jepson, Bookstore Owner

Purpose and Terms of the Loan

<i>Purpose & Terms</i>	To open a mystery bookstore in a suburban mall. Mystery books have caught the eye of young and old readers in the area. Jepson’s market research suggests a mall store can sell \$50,000 worth of books per month. The loan proceeds were used for a new store layout and books. Initial costs were \$100,000. Jepson was given a loan of \$75,000. She paid the rest out of her savings account. At 12 percent fixed interest rate for five years, monthly loan payments are \$1,668 per month and will be made from the profits of the bookstore.
<i>Appraised Value</i>	
<i>Payment History</i>	
<i>Monthly Revenue</i>	
<i>Financial Statement</i>	

EXAMINING A VIRTUAL BANK

Monthly Revenue (earnings) and Costs as of July 1: (6 months after loan was made)

Sales Revenue: \$50,000

Costs:

Rent: \$5,000

Books/materials:\$25,000

Wages for employees:\$15,000

Personal Financial Statement as of July 1: (6 months after loan was made)

Assets:

Bookstore: \$110,000

Savings: \$30,000

Car: \$10,000

House: \$50,000

Liabilities:

Bookstore: \$68,000

Credit Card:\$4,000

Car: \$6,000

House: \$40,000

Personal Debt: (Monthly payments)

Bookstore: \$1,668

Home Mortgage: \$1,000

Car Loan: \$500

Credit Card:\$100

Payment History:

The loan was made on January 1.

As of July 1, Judy is paying the loan as agreed.

February and March were slow for the bookstore, and Judy was late making these payments.

Appraised Value:

The bank received a certified appraisal on the bookstore, including its business assets and contents.

The appraised value was \$110,000.

EXAMINING A VIRTUAL BANK

FINAL REVIEW:

Overall, the experts rate this loan as a passing loan.

CAPITAL:

The experts chose “good!”

Judy’s net worth equals her assets of \$200,000 minus her liabilities of \$118,000. Net worth is \$82,000. The repayment source for the loan is the income from the bookstore, which can be irregular. However, Judy has a consistent payment history.

CAPACITY:

The experts chose “adequate!”

Judy’s capacity to pay the loan is pretty tight. Total monthly income equals \$5,000. Total monthly debt equals \$3,268. The winter months are very slow for the bookstore.

CONDITION:

The experts chose “adequate!”

The bookstore seems to be making money except during the slow winter months, but it appears that other months compensate for those.

COLLATERAL:

The experts chose “good!”

The loan-to-value ratio is good at $\$75,000/\$110,000 = 68\%$. However, should the bank need to liquidate the assets to cover the loan, the assets of the bookstore are specialized and are not considered very marketable. This, of course, would be the worst-case scenario.

CHARACTER:

The experts chose “good!”

Judy seems willing to work and to keep the business running. Even though February and March were difficult months, Judy pulled through with her payments and got herself current again.

