Chapter 8: Banks and Capital Markets

Banks, other financial institutions, and capital markets deal with money, credit, saving, and investment.

They play three fundamental roles:

- **Allowing savers to set money aside and earn returns for future use**
- **Enabling businesses and households to borrow for their investment and spending needs**
- **Spreading risk and allocating it to those most able or willing to bear it**

Let's start with some key concepts that can cause confusion because they have several meanings:

- **Money**: money is (a) a means of exchange, (b) unit of account, and (c) store of value. Money can be anything that people accept for these functions—from seashells and coins to digital accounts!
- **Credit**: can mean lending of money or a positive entry into a bank account or accounting book; lending money can be for various types of economic agents and purposes, for example businesses for investment, households for large purchases, or governments to fund budget deficits
- **Investment**: (a) for business or government, it means building or buying long-lasting goods like roads, factories, or machinery that generate benefits over long periods of time; (b) in personal finance, it means buying financial assets like bonds or stocks that generate returns in the form of income or future sale of the asset
- **Capital**: items that can be used and generate benefits for their owner; capital can be physical (e.g., factories and machinery) or financial (e.g., money available for use by a business or individual)
- **Saving**: setting money aside for future use instead of spending it now. The after-tax income earned by individuals is split between consumption and saving. Consumption normally accounts for the larger share, but saving is important for emergencies, future purchases, retirement, etc.

A key distinction is between **banks** and **capital markets**: banks take deposits and make loans, while capital markets create a direct link between users and providers of capital. For example in the stock market, investors provide equity capital to companies or exchange shares with other equity investors; in the bond market, savers lend money to companies and governments. The resultant equity or debt securities are traded in the capital market, establishing a price for them and allowing investors to buy or sell them if they need or have cash.

MAIN TYPES OF FINANCIAL INSTITUTIONS

Here's an overview of the different types of financial institutions and what they do:

- ***Commercial banks*** *accept deposits from the public and extend loans to businesses, households and governments*
- ***Credit unions*** *are cooperative institutions that provide similar services to banks but are owned and operated for the benefit of their members*
- ***Investment banks*** *help companies issue debt and equity capital and manage assets on behalf of investors; they are often combined with commercial banks in universal banks*
- ***Building societies*** *(UK) and* ***savings & loan associations*** *(US) collect deposits and lend money primarily for home purchases or construction*
- ***Insurers*** *provide protection against losses resulting from events such as accidents, theft, or death*
- ***Brokers*** *are intermediaries between investors and securities exchanges, allowing investors to buy or sell assets on the exchange*
- ***Mutual funds*** *pool money from multiple investors to invest in a diversified set of assets; they can be specialized by country, sector, type of security, etc.*
- ***Hedge funds*** *and* ***private equity funds*** *are specialized investment vehicles that seek to generate high returns; hedge funds employ a variety of strategies while private equity funds invest in unlisted companies; both should generally be reserved for more sophisticated investors who understand and can absorb the risks involved*
- ***Financial planners*** *are advisors who can help clients put together a sound financial plan, including investment portfolio, retirement plan, risk management, tax planning, etc.*

Advice and help can thus be obtained from many sources. While some are only used by certain investors, almost everyone will have to deal with banks, mutual funds and insurers:

- Opening a **bank account** has many advantages, from being able to issue checks and automating rent and utility payments to paving the way for future credit cards and loans
- **Mutual funds** are a convenient way to buy diversified sets of stocks or bonds. They can target specific countries, sectors, etc. You should check the investment strategy, track record, and fees of any fund you consider investing in. Active funds try to beat the market while passive funds track the relevant index (e.g., S&P 500 as a broad indicator of the US stock market or FTSE 100 in the UK). Exchange Traded Funds (ETFs) are types of index funds; they can be a good addition to a portfolio as they offer diversification and liquidity at low costs.
- **Financial planners** and advisors can provide useful advice and perspective; you should make sure they have solid credentials, understand your personal situation, and have interests that are fully aligned with yours.

Here are a few things you should watch out for in investment relationships:

- Hidden costs: these can include trading expenses, commissions, wide buy/sell spreads, etc.
- Inadequate risk/reward profile: for example, funds with high leverage or risks that are not fully understood by investors
- Conflicts of interest: for example, undisclosed sales commissions, self-dealing, or income that depends on factors unrelated to investment performance