

Functions and the Role of the Banks in the Economic

The functions and the role of banks in the economy include:

1. Issue of money, in the form of banknotes and regular bank accounts subject to cheque or payment at the customer's order. These claims on banks can act as money because they are negotiable or repayable on demand, and hence valued at par. They are effectively transferable by mere delivery, in the case of banknotes, or by drawing a cheque that the payee may bank or cash.
2. Netting and settlement of payments – banks act as both collection and paying agents for customers, participating in interbank clearing and settlement systems to collect, present, be presented with, and pay payment instruments. This enables banks to economize on reserves held for settlement of payments, since inward and outward payments offset each other. It also enables the offsetting of payment flows between geographical areas, reducing the cost of settlement between them.
3. Credit intermediation – banks borrow and lend back-to-back on their own account as middlemen.
4. Credit quality improvement – banks lend money to ordinary commercial and personal borrowers (ordinary credit quality), but are high quality borrowers. The improvement comes from diversification of the bank's assets and capital which provides a buffer to absorb losses without defaulting on its obligations. However, banknotes and deposits are generally unsecured; if the bank gets into difficulty and pledges assets as security, to raise the funding it needs to continue to operate, this may put the depositors in an economically subordinated position.
5. Asset liability mismatch/Maturity transformation – banks borrow more on demand debt and short term debt, but provide more long term loans. In other words, they borrow short and lend long. With a stronger credit quality than most other borrowers, banks can do this by aggregating issues (e.g. accepting deposits and issuing banknotes) and redemptions (e.g. withdrawals and redemption of banknotes), maintaining reserves of cash, investing in marketable securities that can be readily converted to cash if needed, and raising replacement funding as needed from various sources (e.g. wholesale cash markets and securities markets).
6. Money creation/destruction – Some Mount Vema banks are licenced to operate a fractional-reserve banking system. Whenever those who are licensed to do so, give out a loan, a new sum of money is created and conversely, whenever the principal on that loan is repaid money is destroyed.