Unit II

FEDERAL RESERVE SYSTEM

INTRODUCTION

Central banking system of U.S.A represents the group of 12 Reserve Banks which is known as Federal Reserve System. No country of the world such a group of banks exists but in other countries only one central bank found for example . Bank of England in U.K, reserve bank of India in India, bank of France in France etc. Thus other countries of the world represent centralize reserve banking system where as U.S.A represents decentralize reserve banking system.

Therefore central Banking system of U.S.A is unique of its type in the world. The U.S. central banking system was established on 23 December 1913 by the Federal Reserve Act after a series of financial panics led to the desire for central control of the monetary system in order to alleviate financial crises.

Congress created the Federal Reserve (popularly known as the "Fed") as an independent entity to attend to the nation's credit and monetary needs without undue influence from political pressures. Before it's establishment there was a fear prevailing in USA that entire monetary power should not be centralize in hands of one central bank as it was present in U.K & other European countries. The act formed in 1913 in which the provision has to be made that not less than 8 & not more than 12 Federal Reserve Bank have started.

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Today, the Fed's monetary policy operations are intended to promote stability in the nation's economy; its supervisory and regulatory functions are intended to provide a safer, more flexible banking system; and its work as fiscal agent for the government and clearinghouse for private sector financial transactions promotes efficiency in the overall banking system. In keeping with its independence within the federal government, the system operates without appropriations from Congress. Its income derives primarily from interest on government securities acquired through monetary policy operations, and fees for banking services, with any excess income returned to the Treasury. In this way decentralize central banking system started in USA.

The Federal Reserve System is considered to be an independent central bank because its decisions do not have to be ratified by the President or anyone else in the executive branch of government. The System is, however, subject to oversight by the U.S. Congress. The Federal Reserve must work within the framework of the overall objectives of economic and financial policy established by the government; therefore, the description of the System as "independent within the government" is more accurate.

The Federal Reserve System is the central bank of the United States. It performs five general functions to promote the effective operation of the U.S. economy and, more generally, the public interest. The Federal Reserve

- conducts the nation's monetary policy to promote maximum employment, stable prices, and moderate long-term interest rates in the U.S. economy;

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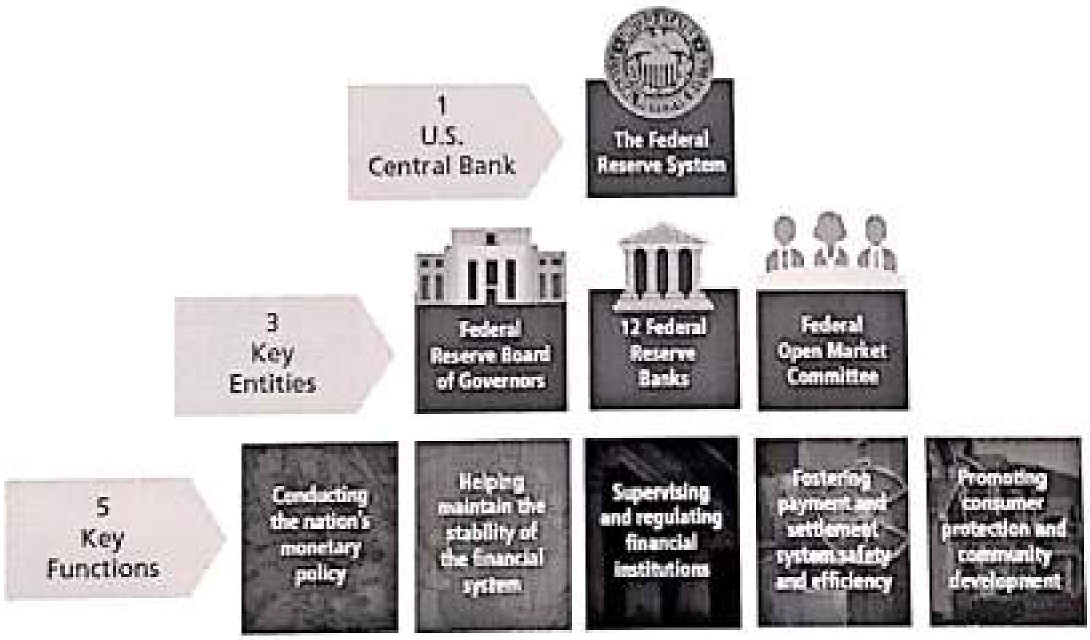
• promotes the stability of the financial system and seeks to minimize and contain systemic risks through active monitoring and engagement in the U.S. and abroad;

• promotes the safety and soundness of individual financial institutions and monitors their impact on the financial system as a whole;

• fosters payment and settlement system safety and efficiency through services to the banking industry and the U.S. government that facilitate U.S.-dollar transactions and payments; and

• promotes consumer protection and community development through consumer-focused supervision and examination, research and analysis of emerging consumer issues and trends, community economic development activities, and the administration of consumer laws and regulations.



ORGANIZATIONAL STRUCTURE OF FEDERAL RESERVE SYSTEM

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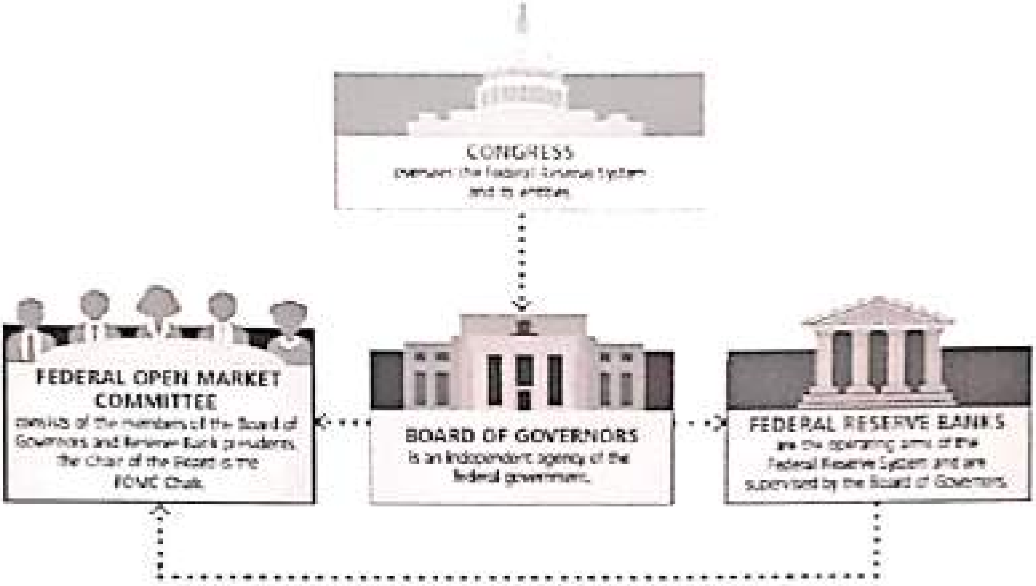
There are four key entities in the Federal Reserve System namely:-

A) Federal Reserve Bank & their branches

B) Board of Governors

C) Federal open market operations committee

D) Federal advisory council



FEDERAL RESERVE BANK & THEIR BRANCHES

A network of twelve Federal Reserve Banks and their carries out a variety of System functions, including operating a nationwide payments system, distributing the nation's currency and coin, supervising and regulating member banks and bank holding companies, and serving as banker for the U.S. Treasury. The twelve Reserve Banks are each responsible for a particular geographic area or district of the United States. Besides carrying out functions for the System as a whole, such as administering nationwide banking and credit policies, each Reserve Bank acts as a depository for the banks in its own District and fulfills other District responsibilities.

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Each Federal Reserve Bank has been established in the form of corporation under Federal Reserve Bank act 1913, Federal Reserve Bank were provided temporary charter which was permanent. For smooth functioning of duties, some Federal Reserve Bank has opened branches within the geographical boundary of their district. Following is the list of 12 Federal Reserve Banks currently operating within the several domestic boundaries of America.

1- Federal Reserve bank Of Boston
2- Federal Reserve bank Of New York
3- Federal Reserve bank Of Philadelphia
4- Federal Reserve bank Of Cleveland
5- Federal Reserve bank Of Richmond
6- Federal Reserve bank Of Atlanta
7- Federal Reserve bank Of Chicago
8- Federal Reserve bank Of St Louis
9- Federal Reserve bank Of Minneapolis
10- Federal Reserve bank Of. Kansas City
11- Federal Reserve bank Of Dallas
12- Federal Reserve bank Of San Francisco

Out of 12 Federal Reserve Bank some are very big & some are very small. The biggest FEDERAL RESERVE BANK in of new York & the smallest is of Minneapolis The FEDERAL RESERVE BANK of new York represents the 25% of total assets of all the FEDERAL RESERVE BANK 's whereas FEDERAL RESERVE BANK of Minneapolis represents only 2 %. Therefore

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due to this diff. each FEDERAL RESERVE BANK Plays a diff. in monitory system.

CAPITAL OF FEDERAL RESERVE BANK

There are two types of commercial bank in USA. Some banks which has been provided licenses by the Central Federal Reserve Bank while other has been provided license by federal states. The first type of bank are known as national bank of second type of banks are knows as state banks. For the national banks the membership of Federal Reserve Bank is compulsory while it is voluntary for state banks. The capital of each Federal Reserve Bank has been subscribe by all the member of commercial within the boundary of that Federal Reserve Bank . They have contributed 3% of their paid up capital & reserve in the capital pool of each Federal Reserve Bank . Though the share of Federal Reserve Bank can be sold to general public & govt. but it has not done so far.

MANAGEMENT OF FEDERAL RESERVE BANK

For smooth and efficient functioning of each Federal Reserve Bank The board of directors has been constituted. These directors has appointed for the period of 3 years. These 9 directors are divided in 3 groups & 3 directors are elected from each group. These 3 groups are as under.

Director of Group A - These directors are elected out of such commercial bank members who have contributed the share capital of FEDERAL RESERVE BANK.

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Director of Group B - Three director of this group are nominated by member of commercial banks out of such persons who represents different important fields of the economy like trade, industry, agriculture, corporation etc. of the district no director of this group can be director officer or employee of any other bank.

Director of Group C - These 3 directors are appointed the Board of Governor of Federal Reserve Bank. These are appointed out of such persons who had been residing in that district at least for the last 24rs & who have special knowledge experience in the field of banking & represents public interest.

BOARD OF GOVERNORS

This is the highest body of Federal Reserve System in USA. The Board of Governors of the Federal Reserve System was established as a federal government agency. The Administration and Congress can have a significant influence on the Fed through control over appointments to the seven-member board. Each of the seven governors is appointed by the President, with the advice and consent of the Senate. The full term of service for a board seat is 14 years and governors may be named to a vacant seat at any point during the term. The appointments are staggered with one term expiring every two years. Governors serving a full term may not be reappointed. Two members hold the leadership positions of chairman and vice chairman of the board. They are designated by the President, with the advice and consent of the Senate. The term of service for both leadership offices is four years; an office holder may be reappointed. These terms do not coincide with that of the President or each other. Although the board

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chairman is considered quite powerful, each governor has one vote on the board.

When selecting a governor, the President is required by law to give due regard to a fair representation of financial, agricultural, industrial, and commercial interests, and geographical divisions of the country. No more than one governor can be selected from any one Federal Reserve district. The members of the Board of Governors cannot hold any office, position, or employment in any member bank during the time they are in office and for two years after.

At present, there are six governors; one position is vacant. The board chairman is Ben S.
Bernanke, whose term as chairman ends in January 2014 and whose term as governor expires in 2020. The vice chairman is Janet L. Yellen, whose term as vice chairman expires in October 2014 and whose term as governor ends in 2024. Governor Elizabeth A. Duke is serving in a term that ends in 2012. Governor Sarah Bloom Raskin is serving in a term that ends in 2016. Governor Kevin M. Warsh is serving in a term that ends in 2018. Governor Daniel K. Tarullo is serving in a term that ends in 2022.

ROLE OF BOARD OF GOVERNOR

MONETARY POLICY

A central responsibility of the Board of Governors of the Federal Reserve System is the formulation of monetary policy. In broad terms, monetary policy involves "influencing the monetary and credit conditions in the

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economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates." In addition, when the Federal Reserve was established, it was given the role of "lender of last resort" to the nation's financial system.

Two less often used monetary policy instruments may be employed by the Federal Reserve—
legal reserve requirements and the discount window. Depository financial institutions are required by law to set aside reserves in certain proportions against demand deposits. What is held in reserve affects the availability of loanable funds. An increase in the requirement would mean banks and thrifts would have less money to lend and would tend to restrain credit conditions. Alternatively, lowering the requirement would increase the proportion of deposits that could be lent and would tend to ease credit conditions. Reserve requirements are rarely changed because as a monetary policy tool they are considered too blunt an instrument.

The discount window is the Federal Reserve facility for lending to eligible depository institutions. An institution may borrow funds for short periods from a Federal Reserve Bank to augment its reserve balances for interbank transactions. The discount rate is the interest rate charged for this short-term loan. The rate is set by each Bank subject to approval by the Board of Governors; over time, it has become common practice for the rate to be uniform for all 12 Reserve Banks. A higher rate discourages borrowing and in turn lending by banks and thrifts. Currently, the discount window serves mainly a signaling function that acts as a complement to open market operations

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In response to the financial crisis that emerged in 2007, the Federal Reserve employed several new tools (in addition to the traditional ones) designed to support the liquidity of depository and other financial institutions and to foster improved conditions in financial markets. The implementation of these new tools resulted in significant changes to the Federal Reserve's balance sheet. During the crisis, the Federal Reserve used its broad emergency authority under Section 13(3) of the Federal Reserve Act to authorize many actions that targeted parts of the financial system outside of the banking system. The Federal Reserve has stated it will continue to employ its policy tools as necessary to support the economic recovery.

SUPERVISION AND REGULATION

The Board of Governors has a broad range of supervisory and regulatory responsibilities that affect the entire U.S. banking system. The board seeks to promote safety and soundness, ensure compliance with laws and regulation, and foster the fair and efficient delivery of services to customers of financial institutions. Federal Reserve Board regulations implement policies set by Congress that are defined in legislation and referred to the Federal Reserve for enforcement. For example, the Fed has implementation and enforcement responsibilities for the Truth in Lending Act, the Electronic Funds Transfer Act, and the Fair Housing Act. The board coordinates its activities with other federal and state regulatory agencies. The board has the power to examine all member banks and their affiliates and to require periodic reports from them.

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The board has the primary responsibility for supervising and regulating bank holding companies and state-chartered banks that are members of the Federal Reserve System. In addition, the board supervises corporations through which U.S. banks conduct operations abroad, and the U.S operations of foreign banks. The board delegates many supervisory duties to the 12 Reserve Banks subject to the board's policy and oversight. An example is the task of conducting bank examinations.

The Board of Governors has broad oversight and supervisory authority over the operations and activities of the Federal Reserve Banks. The board appoints three of the nine directors of each Bank. The board conducts annual financial examinations of the Reserve Banks. Major expenditures, such as building construction, must be approved by the board. The salaries of Reserve Bank presidents and first vice presidents are subject to board approval.

For smooth, effective and efficient functioning of Federal Reserve Bank, BOG has provided wide powers to discharges following functions.

1- It keeps a watch over the working of each Federal Reserve Bank & Examine their book of accounts
2- It collects all important Information & statistics from each Federal Reserve Bank relating to their banking business.
3- It looks offer the note issue work carried by Federal Reserve Bank.
4- It determines the lending & investment power of Federal Reserve Bank.

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5- It fixes the cash reserve ratio for many commercial bank which is to be kept by them with their respective Federal Reserve Bank.
6- It advices Federal Reserve Bank on various banking matter & problems from time to time.
7- It gives approval or communicates the rejection with regard to discount rate proposed by Federal Reserve Bank.

Thus we see that BOG has enough power to control regulate inspect & supervise the working & Federal Reserve Bank.

FEDERAL OPEN MARKET OPERATIONS COMMITTEE

The Federal Open Market Committee (FOMC) is the policy making body for open market
operations—the principal means through which monetary policy is conducted. The seven board members plus five of the 12 Federal Reserve Bank presidents make up the FOMC. The president of the Federal Reserve Bank of New York (New York Fed) is a permanent member because the New York Fed executes the Federal Reserve's monetary policy decisions through open market operations. The remaining four seats are filled by the other 11 presidents on a rotating basis for one-year terms. The rotating seats are filled from the following four groups of Banks, one Bank president from each group: Boston, Philadelphia, and Richmond; Cleveland and Chicago; Atlanta, St. Louis, and Dallas; and Minneapolis, Kansas City, and San Francisco. An alternate for each Reserve Bank president also is elected. This alternate, who must be a president or first vice president of a

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Reserve Bank, may serve on the FOMC in the absence of the relevant Reserve Bank president.

All of the presidents participate in the FOMC meetings and contribute their views, but only the five members vote. The committee elects a chairman and vice chairman. Traditionally, the chairman of the Board of Governors is elected chairman of the FOMC and the New York Fed's president is elected vice chairman.

This committee occupies an important place in the structure of Federal Reserve System. This committee has the power to decide as to when & in what quantity the government security foreign currency, banker acceptance, bill of exchange the should be brought & sold in the money market. Open market operations involve the purchase and sale of government securities in the secondary market by the Federal Reserve. The operations are conducted to keep the federal funds rate close to a target rate that is set by the FOMC. The Federal Reserve System's portfolio is composed of U.S. Treasury securities, federal agency securities, and banker's acceptances. The Federal Reserve Bank of New York holds the portfolio and through its trading desk conducts open market operations pursuant to directives of the FOMC.

All the presidents participate in FOMC discussions, contributing to the committee's

assessment of the economy and of policy options, but only the five presidents who are committee members vote on policy decisions. The FOMC, under law, determines its own internal organization and by tradition elects the Chairman of the Board of

Governors as its chairman and the president of the Federal Reserve Bank of New York as its vice chairman. Formal meetings typically are held eight

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times each year in Washington, D.C. Telephone consultations and other meetings are held when needed.

FEDERAL ADVISORY COUNCIL

The Federal Reserve System uses advisory committees in carrying out its varied
responsibilities. Three of these committees advise the Board of Governors directly:

- ***Federal Advisory Council.*** This council, which is composed of twelve representatives of the banking industry, consults with and advises the Board on all matters within the Board's jurisdiction. It ordinarily meets four times a year, as required by the Federal Reserve Act. These meetings are held in Washington, D.C., customarily on the first Friday of February, May, September, and December. Annually, each Reserve Bank chooses one person to represent its District on the Federal Advisory Committee, and members customarily serve three one-year terms and elect their own officers.
- ***Consumer Advisory Council.*** This council, established in 1976, advises the Board on the exercise of its responsibilities under the Consumer Credit Protection Act and on other matters in the area of consumer financial services. The council's membership represents the interests of consumers, communities, and the financial services industry. Members are appointed by the Board of Governors and

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serve staggered three- year terms. The council meets three times a year in Washington, D.C., and the meetings are open to the public.

- ***Thrift Institutions Advisory Council.*** After the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, which extended to thrift institutions the Federal Reserve's reserve requirements and access to the discount window, the Board of Governors established this council to obtain information and views on the special needs and problems of thrift institutions. Unlike the Federal Advisory Council and the Consumer Advisory Council, the Thrift Institutions Advisory Council is not a statutorily mandated body, but it performs a comparable function in providing firsthand advice from representatives of institutions that have an important relationship with the Federal Reserve. The council meets with the Board in Washing- ton, D.C., three times a year. The members are representatives from savings and loan institutions, mutual savings banks, and credit unions. Members are appointed by the Board of Governors and generally serve for two years.

The Federal Reserve Banks also use advisory committees. Of these advisory committees, perhaps the most important are the committees (one for each Reserve Bank) that advise the Banks on matters of agriculture, small business, and labor. Biannually, the Board solicits the views of each of these committees by mail.

SUMMARY

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Pursuant to the Federal Reserve Act, each of the 12 Reserve Banks is separately incorporated and has a nine-member board of directors. Commercial banks that are members of the Federal Reserve System hold stock in their District's Reserve Bank and elect six of the Reserve Bank's directors; three remaining directors are appointed by the Board of Governors. Most Reserve Banks have at least one Branch, and each Branch has its own board of directors. Branch directors are appointed by either the Reserve Bank or the Board of Governors.

Directors serve as a link between the Federal Reserve and the private sector. As a group, directors bring to their duties a wide variety of experiences in the private sector, which gives them invaluable insight into the economic conditions of their respective Federal Reserve Districts. Reserve Bank head-office and Branch directors contribute to the System's overall understanding of the economy.

The Federal Reserve is not funded by congressional appropriations. Its operations are financed primarily from the interest earned on the securities it owns—securities acquired in the course of the Federal Reserve's open market operations. The fees received for priced services provided to depository institutions—such as check clearing, funds transfers, and automated clearinghouse operations—are another source of income; this income is used to cover the cost of those services. After payment of expenses and transfers to surplus (limited to an aggregate of $10 billion), all the net earnings of the Federal Reserve Banks are transferred to the U.S. Treasury

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