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CHAPTER 2

THE IMPACT OF GOVERNMENT POLICY AND REGULATION ON THE FINANCIAL-SERVICES INDUSTRY

Goal of This Chapter: This chapter is devoted to a study of the complex regulatory environment that governments around the world have created for banks and other financial-service firms in an effort to safeguard the public's savings, bring stability to the financial system, and prevent abuse of financial-service customers.

Key Topics Presented in This Chapter

- The Principal Reasons for Banking and Financial-Services Regulation
- Major Financial-Services Regulators and Laws
- The Riegle-Neal and Gramm-Leach-Bliley (GLB) Acts
- The Check 21, FACT, Patriot, Sarbanes-Oxley, Bankruptcy Abuse, Federal Deposit Insurance Reform, and Financial-Services Regulatory Relief Acts
- Emergency Economic Stabilization Act and the Global Credit Crisis
- FINREG is passed into law to avoid severe disruption in the financial system and deal with systemic risk
- Some Key Regulatory Issues Left Unresolved
- The Central Banking System
- Organization and Structure of the Federal Reserve System and Leading Central Banks of Europe and Asia
- Financial-Services Industry Impact of Central Bank Policy Tools

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VII. Summary of the Chapter

Concept Checks

2-1. What key areas or functions of a bank or other financial firm are regulated today?

Among the most important areas of banking subject to regulation are the adequacy of a bank's capital, the quality of its loans and security investments, its liquidity position, fund-raising options, services offered, and its ability to expand through branching and the formation of holding companies.

2-2. What are the *reasons* for regulating each of these key areas or functions?

These areas are regulated, first of all, to primarily protect the safety of the depositors' funds so that the public has some assurance that its savings and transactions balances are secure. Thus, bank failure is viewed as something to be minimized. There is also a concern for maintaining competition and for ensuring that the public has reasonable and fair access to banking services, especially credit and deposit services. Banks and their closest competitors are also regulated because they provide individuals and businesses with loans that support consumption and investment spending. The fact that governments rely upon banks to assist in conducting economic policy, in collecting taxes, and in dispensing government payments is also one of the reasons for regulation.

2-3. What is the principal role of the Comptroller of the Currency?

The Comptroller of the Currency charters and supervises the activities of national banks through its policy-setting and examinations. In addition, the Comptroller's office must approve all applications for the establishment of new branch offices and any mergers where national banks are involved. The Comptroller can close a national bank that is insolvent or in danger of imposing substantial losses on its depositors.

2-4. What is the principal job performed by the FDIC?

The Federal Deposit Insurance Corporation (FDIC) insures the deposits of bank customers, up to a total of $250,000 per account owner, in banks that qualify for a certificate of federal insurance coverage. This is to enhance public confidence in the banking system. The FDIC is a primary federal regulator (examiner) of state-chartered, non-member banks. It requires all insured depository institutions to submit reports on their financial condition.

2-5. What key roles does the Federal Reserve System perform in the banking and financial system?

The Federal Reserve System supervises and examines the activities of state-chartered banks that choose to become members of its system and qualify for Federal Reserve membership and regulates the acquisitions and activities of bank holding companies. However, the Fed's principal responsibility is monetary policy—the control of money and credit growth in order to achieve broad economic goals. It also serves as a lender of last resort by providing temporary loans to depository institutions facing financial emergencies. The system helps stabilize the financial markets and the economy in order to preserve public confidence.

2-6. What is the Glass-Steagall Act, and why was it important in banking history?

The Glass-Steagall Act, passed by the U.S. Congress in 1933, was one of the most comprehensive pieces of banking legislation in American history. It created the Federal Deposit Insurance Corporation to insure smaller-size bank deposits, imposed interest-rate ceilings on bank deposits, and separated commercial banking from investment banking, thereby removing commercial banks from underwriting the issue and sale of corporate stocks and bonds in the public market.

There are many people who feel that banks should have some limitations on their investment banking activities. These analysts focus on two main areas. First, they suggest that this service may cause problems for customers using other bank services. For example, a bank may require a customer getting a loan to purchase securities of a company it is underwriting. This potential conflict of interest concerns some analysts. The second concern deals with whether the bank can gain effective control over an industrial organization. This could make the bank subject to additional risks or may give unaffiliated industrial organizations a competitive disadvantage.

Today, banks can underwrite securities as part of the Gramm-Leach Bliley Act (Financial Services Modernization Act). However, congress built in several protections to make sure that banks do not take advantage of customers. In addition, banks are prevented from affiliating with industrial firms under this law.

2-7. Why did the federal insurance system run into serious problems in the 1980s and 1990s? Can the current federal insurance system be improved? In what ways?

The FDIC, which insures U.S. bank deposits up to a certain level, was not designed to deal with system-wide failures or massive numbers of failing banks. Yet, the 1980s ushered in more bank closings than in any period since the Great Depression of the 1930s, bringing the FDIC to the brink of bankruptcy. Also, the FDIC's policy of charging the same insurance fees to all banks regardless of their risk exposure encouraged more banks to gamble and accept greater risk. The recent FDIC Improvement Act legislation has targeted this last area, with movement toward a risk-based insurance schedule and greater insistence on maintaining adequate long-term bank capital. However, even today, the federal government sells relatively cheap deposit insurance that may still encourage greater risk taking.

2-8. How did the Equal Credit Opportunity Act and the Community Reinvestment Act address discrimination?

The Equal Credit Opportunity Act stated that individuals could not be denied a loan because of their age, sex, race, national origin or religious affiliation or because they were recipients of public welfare. The Community Reinvestment Act prohibited banks from discriminating against customers based on the neighborhood in which they lived.

2-9. How does the FDIC deal with most failures?

Most bank failures are handled by getting another bank to take over the deposits and clean assets of the failed institution—a process known as purchase and assumption. Those that are small or in such bad shape that no suitable bids are received from other banks are closed and the insured depositors are paid off—a deposit payoff approach. Larger failures may sometimes be dealt with by open bank assistance where the FDIC loans money to the troubled bank and may order a change in management as well. Large failing money-center banks may also be taken over and operated as "bridge banks" by the FDIC until disposed of.

2-10. What changes have occurred in U.S. banks' authority to cross state lines?

In 1994, the Riegle-Neal Interstate Banking and Efficiency Act was passed. This law is complicated but allows bank holding companies with adequate capital to acquire banks or bank holding companies anywhere in U.S. territory. No bank holding company can control more than 10% of the deposits at the national level and more than 30% of the deposits at the state level (unless a state waives this latter restriction). Bank holding companies are also not allowed to cross state lines solely for the purpose of collecting deposits. Banks must adequately support their local communities by providing loans there. Bank holding companies are also allowed to offer a number of interstate services without necessarily having branches in the state by allowing affiliated banks to act as agents for the bank holding in other states. This law also allows foreign banks to branch in the U.S. under the same rules as domestic banks. However, the U.S. Banks still face a few restrictions on their branching activity.

2-11. How have bank failures influenced recent legislation?

Recent bank failures have caused huge losses to federal insurance reserves and damaged public confidence in the banking system. Recent legislation has tried to address these issues by providing regulators with new tools to deal with the failures, such as the bridge bank device, and by granting banks, through regulation, somewhat broader service powers and more avenues for geographic expansion through branch offices and holding companies in order to help reduce their risk exposure. In addition, the increase in bank failures has led to a focus on the insurance premiums banks pay through the FDIC Improvement Act..

2-12. What changes in regulation did the Gramm-Leach-Bliley (Financial Services Modernization) Act bring about? Why?

The most important aspect of the law is to allow U.S. banks, insurance companies, and securities companies to affiliate with each other either through a holding company structure or through a bank subsidiary. The purpose of this law is to allow these companies to diversify their service offerings and reduce their overall risk exposure. In addition, it is thought that this seems to offer customers the convenience of one-stop shopping.

2-13. What new regulatory issues remain to be resolved now that interstate banking is possible and security and insurance services are allowed to commingle with banking?

There are several key issues that remain to be resolved. One issue is concerned with what we should do about the governmental safety net. We need to balance risk taking by financial firms with safety for depositors. We must also consider the issue of how to protect taxpayers, if financial firms are allowed to take on more risk.

Another issue that needs to be resolved is what to do about financial conglomerates. We need to be sure that financial conglomerates do not use the resources of the bank to prop another aspect of their business. In addition, regulators need to be better trained to adequately regulate the more complex organizations and functional regulation needs to be reviewed periodically to make sure it is working.

Another thing that must be resolved is whether banking and commerce should be mixed. Should a bank sell cars along with credit cards and other financial services?

2-14 Why must we be concerned about *privacy* in the sharing and use of a financial-service customer's information? Can the financial system operate efficiently if sharing nonpublic information is forbidden? How far, in your opinion, should we go in regulating who gets access to private information?

It is important to be concerned about how private information is shared because it is possible to misuse the information. For example, if an individual's medical condition is known to the bank through its insurance division, the bank may deny a loan based on this confidential information. They can also share this information with outside parties unless the customer states in writing that this information cannot be shared.

On the other hand, there could be much duplication of effort if no sharing of information is allowed. This would lead to inefficiencies and higher costs to consumers. In addition, sharing of information would allow targeting of services to particular customer needs. At this point, no one is quite sure what information and how it will be shared. It appears that there will eventually be a compromise between customers' needs for privacy and the financial-services company's need to share that information.

2-15. Why were the Sarbanes-Oxley, Bank Secrecy, and USA Patriot Acts enacted in the United States? What impact are these laws and their supporting regulations likely to have on the financial-services sector?

The Bank Secrecy Act (passed originally in 1970 to combat money laundering) requires any cash transaction of $10,000 or more be reported to the government and was passed to prevent money laundering by criminal organizations. The USA Patriot Act was enacted after the attacks of September 11 and is designed to find and prosecute terrorists. It made a series of amendments to the Bank Secrecy Act.
Both acts require banks and financial service providers to establish the identity of any customer opening or changing accounts in the United States. Many banks are however concerned about the cost of compliance.

The Sarbanes-Oxley Accounting Standards Act came as a response to the disclosure of manipulation of corporate financial reports and questionable dealings among leading commercial firms, banks and accounting firms. It prohibits false or misleading information about the financial performance of banks and other financial service providers and generally tries to enforce higher standards in the accounting profession.

2-16 Explain how the FACT, Check 21, 2005 Bankruptcy, Financial Services Regulatory Relief, and Federal Deposit Insurance Reform Acts are likely to affect the revenues and costs of financial firms and their services to customers.

FACT requires the Federal Trade Commission to make it easier for individuals victimized by identity theft to file a theft report and requires credit bureaus to help victims resolve the problems. This should make it easier for customers to handle identity theft problems and may reduce costs to the financial institutions that serve these customers. Financial institutions should be able to spend less on reimbursing customers for theft problems and perhaps the instances of identity theft will also be reduced at the same time.

Check 21 allows financial institutions to send substitute checks to other banks to clear checks rather than paper checks. The substitute checks can be electronic images that can be transferred in an instant at a much lower cost to other institutions. This should reduce costs to institutions as they do not have to have an employee physically transfer checks anymore. In addition, financial institutions should know more quickly whether a check is good and this should reduce fraud and other costs associated with bad checks.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 requires all higher income borrowers who have gone bankrupt to pay back at least a portion of the money they have borrowed. Such bankrupts will be required to make payment plans rather than have all of their debts forgiven. This should lower bad debt costs to financial institutions and may lower borrowing costs for all borrowers.

The Financial Services Regulatory Relief Act of 2006 loosens regulations on depository institutions, adds selected new service powers to these institutions, and grants the Federal Reserve authority to pay interest on depository institutions' legal reserves if deemed necessary.

The Federal Deposit Insurance Reform Act raised the deposit insurance limit for certain retirement accounts and allowed regulators to periodically adjust deposit insurance limits for inflation. This should allow investors to put more money into insured deposit accounts and may allow banks to have a more stable and reliable source of funds for loans and other investments. This will probably have the effect of increasing bank revenues and/or reducing expenses for the bank.

For all of these new laws, the effect should be to make the bank more profitable because of higher revenues and/or lower expenses. At the same time these new laws allow financial institutions to better serve their customers.

2-17 In what ways is the regulation of nonbank financial institutions different from the regulation of banks in the United States? How are they similar?

Most nonbank financial institutions are considered "vested with the public interest" and therefore, face as close supervision from federal and state supervisors as banks do. However, some institutions are solely regulated at the federal level while others are only regulated at the state level.

2-18 Which financial-service firms are regulated primarily at the federal level and which at the state level? Can you see problems in this type of regulatory structure?

Federal Credit Unions: They are supervised and examined by the National Credit Union Administration (NCUA).
Savings and Loans and Savings Banks ("Thrifts"): State-chartered associations are supervised and examined by state boards or commissions, whereas federally chartered savings associations fall under the jurisdiction of the Office of the Comptroller of the Currency (OCC), after the Dodd-Frank Regulatory Reform Act was passed in 2010.
Money Market Funds: They are regulated at a federal-level by the Securities and Exchange Commission.
Life and Property/Casualty Insurance Companies: State insurance commissions generally regulate the insurance companies with regard to the types of insurance policies sold, maximum premium rates, and etc. They are also federally regulated by the Securities and Exchange Commission with regard to the equity or debt securities sold by these companies.
Finance Companies: These businesses and consumer lenders have been regulated at the state government level for the types and contents of loan agreements offered, the interest rates charged, and the recovery procedures adopted.
Mutual Funds: These face close scrutiny from both federal and state regulation. The SEC also requires these businesses to register, submit periodic financial reports, and provide investors with a prospectus that reveals the financial condition, recent performance, and objectives of each fund.

Security Brokers and Dealers and Investment Banks: These are regulated at both federal and state levels. The chief federal regulator is the SEC and requires the firms to submit periodic reports, limits the volume of debt they take on, and investigates insider trading practices.
Hedge Funds, Private Equity Funds, and Venture Capital Companies: These face almost no kind of regulation, but the SEC does oversee the information these firms provide to the public.
Some regulators and experts are concerned because they feel that state regulators might not have the expertise to deal with the new more complex financial firm that exists today. They are also concerned because the new 'functional' regulation is not necessarily coordinated between different regulatory agencies. Only time will tell if this functional regulatory structure is effective.

2-19 Can you make a case for having only one regulatory agency for financial-service firms?

Yes, a case can easily be made for financial service firms. Problems in one area such as security brokerage services or insurance may eventually lead to problems in the traditional banking area or vice versa. One regulatory agency might be more likely to find these overlapping problems and prevent them before they cause the collapse of the entire organization. In addition, one regulatory agency may be able to better identify and prevent the inherent conflicts of interest that exist when a large financial conglomerate is formed.

2-20 What is *monetary policy*?

Monetary policy consists of regulation and control over the growth of money and credit in an attempt to pursue broad economic goals such as full employment, reduction of inflation, and sustainable economic growth. Its principal tools are open market operations, changes in the discount (lending) rate, and changes in reserve requirements behind deposits.

2-21 What services does the Federal Reserve provide to depository institutions?

Many services needed by banks are provided by the Federal Reserve banks. Among the most important services provided by the Fed are checking clearing, the wiring of funds, shipments of currency and coin, safekeeping securities of depository institutions and their customers, issuing new securities from the U.S. Treasury and selected other federal agencies, loans from the Reserve banks to qualified depository institutions, and the supplying of information concerning economic and financial trends and issues. The Fed began charging for its services in order to help recover the added costs of deregulation which made more institutions eligible for Federal Reserve services and also to encourage the private marketplace to develop and offer similar services (such as check clearing and wire transfers).

2-22 How does the Fed affect the banking and financial system through open market operations (OMO)? Why is OMO the preferred tool for many central banks around the globe?

Open market operations consist of the buying and selling of securities by the central bank in an effort to influence and shape the course of interest rates and the growth of money and credit. Open-market operations, therefore, affect bank deposits—their volume and growth—as well as

the volume of lending and the interest rates attached to bank borrowings and loans as well as the value of bank stock. OMO is the preferred tool, because it is also the central bank's most flexible tool. It can be used every day and any mistakes can be quickly reversed.

2-23 What is a *primary dealer*, and why are they important?

A primary dealer is a dealer in U.S. Treasury Bills and other securities that meets the Federal Reserve System requirements for trading directly with the Fed's trading desk inside the New York Federal Reserve. It is through these trades with primary dealers that the Federal Reserve carries out its monetary policy objectives and influences the economy including the supply of money and credit and interest rates. Primary dealers have an integral role to play in the economy of the U.S.

2-24 How can changes in the central bank loan (discount) rate and reserve requirements affect the operations of depository institutions? What happens to the legal reserves of the banking system when the Fed grants loans through the discount window? How about when these loans are repaid? What are the effects of an increase in reserve requirements?

The Discount Window is the department in each Federal Reserve Bank that receives requests to borrow reserves from banks and other depository institutions which are eligible to obtain credit from the Fed for short periods of time. The rate charged on such loans is called the discount rate.

Reserve requirements are the amount of vault cash and deposits at the Federal Reserve banks that depository institutions raising funds from sources of reservable liabilities (such as checking accounts, business CDs, and borrowings of Eurodollars from abroad) must hold.

If the Fed grants loans worth $200 million to borrowing institutions from the discount window, their total reserves will rise by the amount of the discount window loan, but then will fall when the loan is repaid.

Increasing reserve requirement means that depository institutions must keep more vault cash and reserves with the Federal Reserve for each deposit account they hold. This would have the effect of making less money available for loans. Since this has a multiplicative effect on the economy, it can have a severe effect on the total amount of loans made and on the growth of the money supply that results.

2-25 How did the Federal Reserve change the policy and practice of the discount window recently? Why was this change made?

The Fed created two new loan types, primary and secondary credit, which replaced the existing adjustment and extended credit.
Primary credit is extended to sound borrowing institutions at a rate slightly higher than the federal funds rate.
Secondary credit is extended to institutions that do not qualify for primary credit for temporary funding needs at a rate slightly above the prime rate.

In 2003, the Fed began setting the discount rate slightly above its target federal funds rate to promote greater stability. In 2007 and 2008, the Fed's discount window was opened wide in an effort to provide additional liquidity to banks under pressure from the home mortgage crisis.

These changes were implemented to encourage greater use of the discount window and to bring greater stability to the federal funds rate and to the money market as a whole.

2-26 How do the structures of the European Central Bank (ECB), the Bank of Japan, and the People's Bank of China appear to be similar to the structure of the Federal Reserve System? How are these powerful and influential central banks different from one another?

Like the Fed, the ECB consists of a governing council and a policy making council. The ECB also has a cooperative arrangement with each EU member nation's central bank like the Fed's board of governors works with the 12 regional Federal Reserve banks. The policy menu of the ECB however is a lot simpler than its counterpart at the Fed. The central goal is price stability, which is largely achieved through open market operations and reserve requirements.

Much like the Fed's Federal Open Market Committee, the People's Bank of China's (PBC) pursuit of monetary policy is supported by an advisory group. The Monetary Policy Committee (MPC), which meets at least quarterly and includes the PBC's Governor, the Chair of the China Bank Regulatory Commission, the Finance Minister, and other members of the Chinese government.

The Bank of Japan (BOJ) regulates the volume of money and interest rates through open market operations (using securities issued by the Japanese government and commercial bills), by providing emergency loans to institutions in trouble and through the use of moral suasion to convince financial mangers to adhere to the BOJ's policies.

However, the Bank of Japan, the People's Bank of China, and central banks in other parts of Asia appear to be under close control of their governments, and several of these countries have experienced higher inflation rates, volatile currency prices, and other significant economic problems in recent years.

2-27 How did the Federal Reserve and selected other central banks expands their policy tools to deal with the great credit crisis of 2007–2009? Did their efforts work satisfactorily?

Besides the traditional policy tools of open market operations, discount rates, reserve requirements, and moral suasion the Federal Reserve established two new policy tools in 2007 and 2008 to help stem the damage created by the home mortgage crisis. The Term Auction Facility (TAF) and the Term Securities Lending Facility (TSLF) were designed to make loans to depository institutions and securities dealers for periods of approximately one month to increase the supply of liquidity in the financial markets and expand credit for businesses and consumers. Four other central banks—the British, Canadian, Swiss, and European central banks—supported the Fed's action and moved in parallel fashion to encourage their countries' banks to expand the supply of credit.

Problems

2-1. For each of the actions described, explain which government agency or agencies a financial manager must deal with and what laws are involved:

A. Chartering a new bank.
B. Establishing new bank branch offices.
C. Forming a bank holding company (BHC) or financial holding company (FHC).
D. Completing a bank merger.
E. Making holding company acquisitions of nonbank businesses.

A. For chartering a new bank in the United States either the state banking commission of the state, where the bank is to be headquartered must be consulted, or the Comptroller of the Currency must be sent an application for a national charter. The National Bank Act governs national charters while state charters are governed by rules laid down in state banking statutes.

B. Requests for establishing new branch offices must also be made of the bank's chartering agency—either the state banking commission for state-chartered banks or the Comptroller of the Currency for national banks in the United States.

C. Requests for holding company formation must be submitted to the Federal Reserve Board or, for certain routine transactions, to the Federal Reserve Bank in the district. Some states require their banking commissions to be notified if a holding company acquires a bank within the state's borders.

D. The Bank Merger Act requires the approval of a bank's principal federal supervisory agency for a proposed merger even if the bank is state chartered. Mergers involving national banks must be approved by the Comptroller of the Currency and by the state banking commission if a bank has a state charter of incorporation. The merger must also be reviewed by other federal agencies that have supervisory responsibility for a bank, such as the FDIC, the Federal Reserve, and by the U.S. Department of Justice.

E. Request for acquisitions of nonbank businesses must be approved by the Federal Reserve Board. For some more routine transactions, the Federal Reserve Bank in the district can make the decision.

2-2. See if you can develop a good case for and against the regulation of financial institutions in the following areas:

A. Restrictions on the number of new financial-service institutions allowed to enter the industry each year.
B. Restrictions on which depository institutions are eligible for government-sponsored deposit insurance.
C. Restrictions on the ability of financial firms to underwrite debt and equity securities issued by their business customers.

D. Restrictions on the geographic expansion of banks and other financial firms, such as limits on branching and holding company acquisitions across state and international borders.
E. Regulations on the failure process, defining when banks and other financial firms are to be allowed to fail and how their assets are to be liquidated.

A. Restricting entry into the banking industry limits competition and, to some extent, protects some banks from failure.
On the other hand, restricting entry into the banking industry by means of strict compliance requirements helps protect the interests of the average customer who lacks financial expertise to correctly evaluate the risk involved.

B. Restrictions on which banks can get deposit insurance limits competition but encourages some banks to take on more risk because most depositors are protected by the insurance.
On the other hand, restricting which institutions are eligible for deposit insurance may limit the losses to the federal agency providing that insurance and also help retain public confidence in the financial system.

C. Limits on underwriting securities reduce a bank's revenue potential and will probably result in losing some of the largest corporate customers to foreign banks who face more lenient regulations.
On the hand, underwriting securities is inherently risky and limiting this may limit the risk of the bank. It may also prevent the conflicts of interest that arise when a bank makes loans and underwrites securities at the same time.

D. Limiting a bank's ability to expand geographically exposes it to greater risk of economic fluctuations within its local market area and makes it more prone to failure.
On the other hand, allowing a bank to expand geographically may concentrate power in the hands of a few large institutions that make it more likely that service costs will rise for all customers.

E. Protecting banks from failure inevitably involves sheltering some inefficient and poorly managed institutions that waste resources and fail to serve customers effectively. It also tends to make the average customer less vigilant about the quality and risk of a particular bank's services and operations because deposits are insured and bank failure to most customers, seems to be a relatively remote possibility.
On the other hand, it makes customers more confident in the system as a whole and makes a bank run less likely.

2-3. Consider the issue of whether or not the government should provide a system of deposit insurance. Should it be wholly or partly subsidized by the taxpayers? What portion of the cost should be borne by depository institutions? by depositors? Should riskier depository institutions pay higher deposit insurance premiums? Explain how you would determine exactly how big an insurance premium each depository institution should pay each year. When was the maximum value of federal deposit insurance last changed? By what amount?

If taxpayers subsidize the cost of deposit insurance, depository institutions will be encouraged to take on added risk. Ideally more risky banks should be compelled to pay more for deposit insurance; some of this cost would probably be passed on to depositors who would begin to shift their funds to less risky banks. Eventually banks willing to take on greater risk will find their cost of fund rising to unacceptably high levels and will begin to reduce their risk exposure.

It is not clear how high deposit insurance fees should be set to curtail excessive bank risk-taking, though it seems clear that more risky banks should pay higher insurance fees if we are to move toward a more efficient deposit insurance system. Since there are several dimensions to bank risk exposure, it probably would not be feasible to tie the size of insurance fees to just one indicator.

Perhaps an index of measures of loan-portfolio risk, interest-rate risk, liquidity risk, etc. would be preferable with the appropriate measures based upon research evidence from studies of bank failures. The maximum value of federal deposit insurance was increased to $250,000 in 2008.

2-4. The Trading Desk at the Federal Reserve Bank of New York elects to sell $100 million in U.S. government securities to its list of primary dealers. If other factors are held constant, what is likely to happen to the supply of legal reserves available? To deposits and loans? To interest rates?

If the trading desk sells $100 million in U.S. Government securities, the supply of total legal reserves will decrease by $100 million, some of which will probably be taken from the reserve accounts of the dealers purchasing the securities. Deposits and loans will decrease by a multiple of the new reserves and, initially at least, market interest rates should rise.

2-5. Suppose the Federal Reserve's discount rate is 4 percent. This afternoon, the Federal Reserve Board announces that it is approving the request of several of its Reserve Banks to raise their discount rates to 4.5 percent. What is likely to happen to other interest rates tomorrow morning? Carefully explain the reasoning behind your answer.
Would the impact of the discount rate change described above be somewhat different if the Fed simultaneously <u>sold</u> $100 million in securities through its Trading Desk at the New York Fed?

Other interest rates will also rise following a discount rate increase. Of course, if loan demand were decreasing, market rates could fall despite the upward shift in the discount rate. If the discount rate were increased when loan demand was rising, market rates would almost surely rise, <u>ceteris paribus</u>.

If the Fed sold $100 million in securities this would reinforce the discount-rate increase. Other interest rates would almost certainly rise, if other factors held constant. However, a Fed purchase would encourage lower interest rates, offsetting the discount rate effect.

2-6. Suppose the Fed purchases $500 million in government securities from a primary dealer. What will happen to the level of legal reserves in the banking system and by how much will they change?

Open market operations consist of the buying and selling of securities by the central bank in an effort to influence and shape the course of interest rates and the growth of money and credit. Open market operations, therefore, affect bank deposits—their volume and growth—as well as the volume of lending and the interest rates attached to bank borrowings and loans, as well as the value of bank stock.
If the Fed purchases $500 million in government securities, total bank reserves will increase by $500 million. If the $500 million represents excess reserves, deposits and loans will expand by a multiplicative factor related to the reserve requirements of the various deposits.

2-7. If the Fed loans depository institutions $200 million in reserves from the discount windows of the Federal Reserve banks, by how much will the legal reserves of the banking system change? What happens when these loans are repaid by the borrowing institutions?

The Discount Window is the department in each Federal Reserve Bank that receives requests to borrow reserves from banks and other depository institutions which are eligible to obtain credit from the Fed for short periods of time. The rate charged on such loans is called the discount rate.

Reserve requirements are the amount of vault cash and deposits at the Federal Reserve banks that depository institutions raising funds from sources of reservable liabilities (such as checking accounts, business CDs, and borrowings of Eurodollars from abroad) must hold.

If the Fed loans $200 million in reserves from the discount window, total reserves will rise by the amount of the discount window loan, but then will fall when the loan is repaid. Correspondingly, loans and deposits should rise by a multiple of the increase in reserves depending on reserve requirements for deposits and whether the $200 million is excess reserves or not.

2-8. What happens when a central bank like the Federal Reserve expands its assets? Is there any upper limit to a central bank's assets? Why?

Central banks, just like the Federal Reserve, occasionally uses changes in reserve requirements as a monetary policy tool. Institutions selling deposits must place a small percentage of each dollar of those deposits in reserve, either in the form of vault cash or in a deposit at the central bank. Changes in the percentage of deposits and other funds sources that must be held in reserve can have a significant impact on credit expansion. Raising reserve requirements means that financial firms must set aside more of the amount raised as deposits into required reserves. This leaves less money available to make new loans and may cause a rise in interest rates.

Lowering reserve requirements, on the other hand, releases reserves for additional lending. This can cause interest rates to decline as financial institutions have more funds to loan. However, central banks usually change reserve requirements very infrequently because the impact can be so powerful and cannot easily be reversed and because banks are less dependent on deposits as a source of funds than in the past.

There is no upper limit on the central bank's assets. It raises its own funds from sales of its services and from securities trading, and it passes along most of its earnings to the U.S. Treasury.