

FUNDAMENTALS OF BANKING

CHAPTER XXII

THE FEDERAL RESERVE SYSTEM
AND THE
FEDERAL DEPOSIT INSURANCE CORPORATION

Purposes of this chapter

1. To show some of the principal services Federal Reserve Banks provide member banks and the Government.
2. To point out the way the Federal Reserve influences general credit policy.
3. To describe the organization of the Federal Reserve System.
4. To discuss briefly the Federal Deposit Insurance Corporation.

Questions based on the chapter

1. Why are the Federal Reserve Banks frequently called "bankers' banks"?
2. In what principal ways does the Government use the Federal Reserve Banks?
3. The Federal Reserve System influences commercial bank credit policies by changes in reserve requirements, purchases and sales of Government securities in the open market, and the discount rate. Explain.
4. All large banks have to be members of the Federal Reserve System. (True or false?)
5. In what ways are the Federal Reserve Banks different from commercial banks?
6. The Board of Governors is composed of three bankers, three businessmen, and three representatives of the general public. (True or false?)

7. How does the Federal Deposit Insurance Corporation protect smaller depositors of insured banks?
8. The Comptroller of the Currency is a director of the Federal Deposit Insurance Corporation. (True or false?)

Assignment

List and explain the services and policies of the Federal Reserve that are used by or influence the operations of your bank.

The development and operation of the Federal Reserve System and of the Federal Deposit Insurance Corporation are described in detail in the Institute's textbook, "Money and Banking". The brief discussion of these institutions in this chapter is focused on those activities that bear directly on practical bank operations.

The Federal Reserve System

Services to banks

Many of the preceding chapters contained scattered references to activities of the Federal Reserve System. The Federal Reserve Banks perform for their member banks many of the services that the latter perform for their customers; that is why they are sometimes called "bankers' banks".

Among these services are those relating to:

1. Cash
2. Cash collection
3. Non-cash collection
4. Wire transfer
5. Rediscounting

1. Cash. When a customer has more cash than he wishes to keep, he deposits the excess in his bank; when he needs more cash, he withdraws it from his bank. The bank, of course, decides how much cash it wishes to keep as a working fund and as vault cash. When a member bank acquires more cash than it wishes, it sends the excess to its Federal Reserve Bank to increase its reserve balance or to a correspondent, which sends its excess to the Federal Reserve Bank. If it runs short of the desired amount, it will draw on its reserve balance. Non-member banks generally get their cash from a member bank.

The Federal Reserve Banks keep a large stock of all kinds of paper money and coin to meet this demand. Some of this cash - principally

silver certificates, United States notes, and coin - is issued by the Treasury. The Reserve Banks pay for such Treasury currency by crediting the Treasury's account. The largest amount, however, consists of Federal Reserve notes which the Federal Reserve Banks are authorized to issue. Thus the Treasury, the twelve Federal Reserve Banks, and the thousands of local banks throughout the country distribute cash promptly wherever it is needed and retire it when the need has passed.

2. Cash collection. Payments by check are many times larger than payments made with paper money and coins. A rapid collection system has helped to make checks an acceptable means of payment. The way commercial banks have facilitated the use of checks has been discussed in Chapter V and Chapter XIV.

The Federal Reserve Banks clear and collect checks and provide a means for commercial banks to settle for the checks they clear and collect. This includes checks collected by city correspondent banks and local checks collected by banks through clearing houses or by direct presentation to one another. The settlement or payment for such checks on member banks is made directly or indirectly through member-bank reserve balances with the Federal Reserve Banks.

Checks collected and cleared through the Federal Reserve Banks must be paid in full by the banks on which they are drawn; in other words, they must be payable at par - there is no deduction of fee or charge. Reserve Banks will not collect checks of non-par banks.

An example of the way the Federal Reserve Banks directly facilitate the clearing and collecting of checks follows. Suppose a manufacturer in Rochester sells \$5,000 worth of equipment to a dealer in Portland, Oregon, and receives in payment a check on the dealer's bank in Portland.

The manufacturer deposits the check in his bank in Rochester. He doesn't want cash in exchange for the check, but he wants credit in his deposit account. The Rochester bank does not want currency in exchange for the check, but wants credit in its reserve account with the Federal Reserve Bank of New York. It needs this credit to use as a further basis for extending credit; hence the Rochester bank begins the collection process by sending the check to the Federal Reserve Bank of New York, which sends it to the Federal Reserve Bank of San Francisco which in turn sends it to the bank in Portland, Oregon. The Portland bank charges the check to the account of the depositor who wrote it, and the Federal Reserve Bank of San Francisco charges the Portland bank's reserve account and credits the Federal Reserve Bank of New York. The New York Federal Reserve Bank then credits the Rochester bank's reserve account and the Rochester bank credits the depositor's account. The net effect is a reduction of the reserves and deposits of the debtor's bank in Portland, and an increase in the reserves and deposits of the creditor's bank in Rochester. The Federal Reserve Banks shift reserves from one account to the other, with net holdings remaining the same. In order to facilitate the collection process, Federal Reserve Banks extend to member banks which handle a substantial volume of checks payable in other Federal Reserve Districts the privilege of sending their checks directly to other Federal Reserve Banks. This eliminates the first step. The Rochester bank, therefore, might have sent the \$5,000 check directly to the Federal Reserve Bank of San Francisco for collection, at the same time informing the New York Federal Reserve Bank of its action. The Federal Reserve Bank of New York would credit the Rochester bank's reserve account on the basis of this information.

3. Non-cash collection. Checks are not the only items that banks are called on to convert into usable funds. Notes, acceptances, certificates of deposit, drafts, bills of exchange, bonds, and bond coupons are others. The handling of these items by the collection department of commercial banks is described in Chapter XIV.

The Federal Reserve System has a non-cash collection service much like that of a large commercial bank. Preference is given to par banks, but collections are also sent to banks not collecting at par, which make a reasonable charge.

4. Wire transfer. The Federal Reserve Banks operate a leased-wire system that connects every Federal Reserve Bank and branch with every other Federal Reserve Bank and branch. A member bank may use this service to establish balances or to pay funds immediately in other parts of the country. Such transfers of funds are debited and credited to the reserve accounts of the member banks involved.

5. Rediscounting. One of the advantages of membership in the Federal Reserve System is the privilege of borrowing from a Federal Reserve Bank. A member bank may rediscount one or more of its customers' notes with a Reserve Bank. Also, a member bank may secure an advance from its Federal Reserve Bank by giving its own note secured by paper from its holdings. In either case, the Reserve Bank gives the member bank credit in its reserve account. This increases the reserve deposit of a member bank at the Reserve Bank. For this service a Reserve Bank charges interest at a rate known as the discount rate.

If the collateral used by the member bank does not meet the requirements of eligible paper prescribed by law, the Reserve Bank must charge an extra 1/2 per cent or more of interest. Accordingly, the paper

pledged is usually of prime quality and of short maturity - usually short-term Government securities.

A Reserve Bank is not obliged to grant credit automatically when requested by a member bank. The decision rests on judgment as to the applicant's need and the use to be made of the funds. A discount or advance from a Reserve Bank is considered available to member banks to meet temporary requirements or unusual banking situations.

Services for the Government

The Federal Reserve Banks are used by the Government as fiscal agents, custodians, and depositories. They carry the principal checking accounts of the United States Treasury, do a large part of the work in issuing and redeeming Government obligations, and perform many other fiscal duties for the Government.

1. Treasury deposits. The Government receives and spends funds in all parts of the country. Receipts come mainly from taxpayers and purchasers of Government securities. A large part is deposited initially to the Treasury's account in the commercial banks and is then transferred to the Reserve Banks as needed by the Treasury. The Government spends by check, and checks are charged to Treasury accounts at the Reserve Banks.

2. Government debt. Reserve Banks take applications for the purchase of Government securities, make allotments as instructed by the Treasury, deliver to the purchaser, receive payment, and credit amounts to the Treasury account. Reserve Banks redeem Governments as they mature, make exchanges, and pay interest coupons. They also issue and redeem Savings Bonds.

In size, these services run into astronomical figures. For example, in 1953 the Federal Reserve Banks handled more than three billion checks worth more than a trillion dollars! The volume of operations in various activities is shown in the table on page 9.

Monetary policy

It should be observed that some of these operations affect the reserve balance of the member bank. This is important because individual banks are sensitive to their own reserve position and because the Federal Reserve System exercises its credit controls primarily through influencing the supply, availability, and cost of reserves.

The member bank is sensitive to its reserve position because it is required by law to keep a minimum percentage of its deposits in the form of reserves. It must keep this reserve on deposit with its Federal Reserve Bank. Non-member banks are subject to reserve requirements that vary from state to state. A bank cannot permit its reserve account to fall below its requirements without suffering penalties. On the other hand, a bank ordinarily will not wish to keep its reserve account above its requirements because it receives no income from such excess reserves. As banks acquire excess reserves they tend to lend and invest more readily, and credit becomes easier. As they lose excess reserves they tend to become more selective in their loans and investments, and credit grows tighter.

The Federal Reserve System, in turn, can ease or tighten credit by influencing the volume of reserves. It has three general instruments for this purpose:

1. Changes in reserve requirements
2. Open-market operations
3. Discounting

**VOLUME OF OPERATIONS IN PRINCIPAL DEPARTMENTS OF FEDERAL
RESERVE BANKS, 1950-54**

[Number in thousands; amounts in thousands of dollars]

	1954	1953	1952	1951	1950
NUMBER OF PIECES HANDLED¹					
Discounts and advances:					
Notes discounted and advances made.....	10	20	18	11	8
Industrial loans:					
Loans made.....	.2	.6	1	1.4	.7
Commitments to make industrial loans.....	(²)	(²)	(²)	(²)	(²)
Currency received and counted..	4,384,270	4,405,255	4,183,063	4,066,619	3,846,397
Coin received and counted.....	7,001,838	5,889,238	5,716,379	5,889,223	7,190,498
Checks handled:					
U. S. Govt. checks.....	481,408	458,607	446,084	412,865	365,812
Postal money orders.....	354,368	366,807	371,318
All other ³	2,513,966	2,415,164	2,293,061	2,122,147	1,955,232
Collection items handled:					
U. S. Govt. coupons paid...	12,753	13,703	13,599	14,510	15,323
All other.....	15,443	14,360	14,172	13,428	12,793
Issues, redemptions, and exchanges of U. S. Govt. securities.....	191,112	177,596	163,568	154,335	153,886
Transfers of funds.....	1,808	1,718	1,595	1,525	1,343
AMOUNTS HANDLED					
Discounts and advances.....	22,871,449	93,438,640	105,549,326	43,422,106	17,050,334
Industrial loans:					
Loans made.....	7,477	22,009	31,193	27,656	6,530
Commitments to make industrial loans.....	520	980	3,468	9,078	4,019
Currency received and counted..	28,482,428	29,514,663	27,001,076	26,175,324	24,039,335
Coin received and counted.....	761,062	607,205	558,416	592,664	622,620
Checks handled:					
U. S. Govt. checks.....	141,037,495	140,739,438	119,423,270	89,648,061	64,569,739
Postal money orders.....	5,943,178	6,091,173	5,996,899
All other ³	882,971,848	885,726,031	840,094,629	799,891,846	856,952,849
Collection items handled:					
U. S. Govt. coupons paid...	2,209,045	2,270,606	1,923,079	2,020,560	2,173,589
All other.....	5,085,695	4,615,970	5,103,262	5,121,274	4,758,483
Issues, redemptions, and exchanges of U. S. Govt. securities.....	469,247,400	381,877,330	355,234,532	344,771,945	346,224,112
Transfers of funds.....	1,038,100,606	876,838,475	767,974,539	656,771,175	509,167,912

¹Two or more checks, coupons, etc., handled as a single item are counted as one "piece."

²Less than 50.

³Figures beginning with 1951 exclude checks drawn on the Federal Reserve Banks; the 1950 data include 1,785,000 of such items amounting to \$178,120,377,000.

Source: Annual Report for 1954 of the Board of Governors of the Federal Reserve System, p. 69.

1. Changes in reserve requirements. The Board of Governors of the Federal Reserve System is authorized to change, within limits, the minimum percentage of reserve that member banks must keep against deposits. By reducing reserve requirements, the Board of Governors increases excess reserves of member banks. This induces member banks to lend and invest more readily. On the other hand, when reserve requirements are increased, member banks (unless they have excess reserves) must acquire additional reserves to meet the higher requirements, and credit grows tighter.

2. Open market operations. The Federal Reserve System can put reserves into the banking system directly by buying Government securities and can take them out by selling Government securities in the open market. The System pays for securities with a check drawn on itself. Typically, the seller of the securities deposits the check in his bank, and the bank in turn deposits it to its reserve account at the Federal Reserve Bank. Since no bank has lost reserves, the operation increases the excess reserves not only of the original receiving bank but of the banking system as a whole. When the Federal Reserve buys securities in the market it tends to make credit easier. Conversely, a sale of securities by the System will be paid for by checks, which will reduce both deposits and the reserve balances of member banks. This tends to make for a tighter credit policy.

3. Discounting. A member bank that is short of reserves may restore its position by borrowing from its Federal Reserve Bank and depositing the proceeds of the loan to its reserve account. The Reserve Banks can influence the volume of reserves created in this way by changing the rate of discount on such borrowing. Although most banks prefer not to borrow at all, those that do borrow can be discouraged by a higher rate and encouraged by a lower rate.

Structure of the Federal Reserve System

The organization of the Federal Reserve System is shown on page 12. Instead of establishing a single central bank, the country was divided into twelve districts and a city was selected in each district for the location of a Federal Reserve Bank.

Member banks

All nationally chartered banks are required to be members of the Federal Reserve System. Most of the large state-chartered banks have elected to join the System. So that, while less than half of all banks belong to the System, member banks hold about three-fourths of total bank deposits.

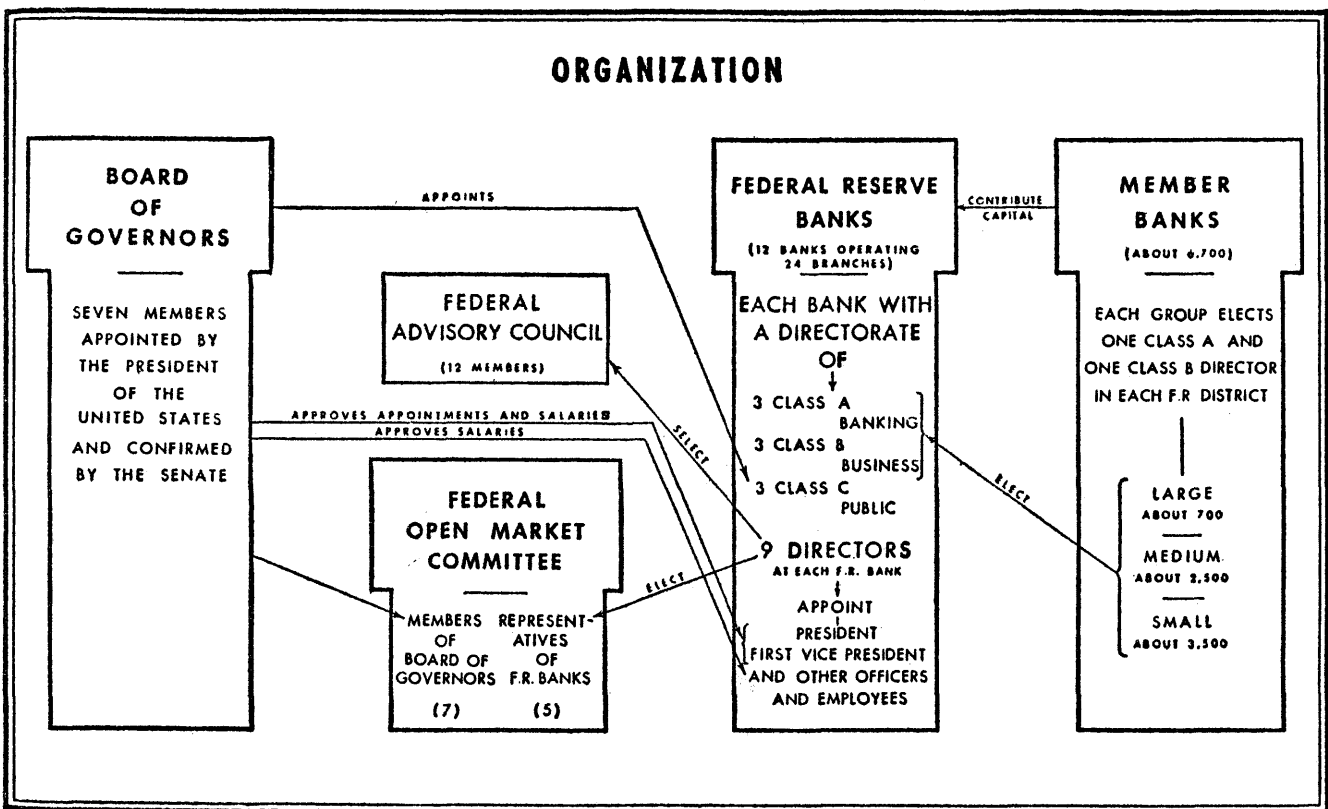
Members are eligible to use all of the System's facilities and must abide by certain regulations for the protection of the public interest. In addition to the services provided by the System that were described on pages 3 through 7, member banks share in the informational facilities of the System, participate in the election of six of the nine directors of the Federal Reserve Bank, and receive a cumulative statutory dividend of 6 per cent on paid-in capital stock of the Reserve Banks.

Federal Reserve Banks

Every member bank subscribes to capital of the Federal Reserve Bank in its district. Each Federal Reserve Bank has nine directors. Three of them are known as Class A directors; three as Class B directors; and three as Class C directors. Class A and B directors are elected by member banks. One of each class (two directors) is elected by small banks; one of each class by banks of medium size; and one of each class by large banks. The three Class A directors may be bankers. The three

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Source: "The Federal Reserve System: Purposes and Functions", p.82.

Class B directors must be actively engaged in the district in business, agriculture, or some other commercial pursuit. The Class B directors must not be officers, directors, or employees of any bank. The three Class C directors are selected by the Board of Governors of the Federal Reserve System. They must not be officers, directors, employees, or stockholders of any bank.

The directors are responsible for the conduct of the Reserve Bank in the public interest, subject to supervision by the Board of Governors. Directors of the Reserve Banks set the discount rate for their respective districts, subject to review and determination by the Board of Governors. The officers of each Federal Reserve Bank are appointed by its board of directors, but the law requires that the president and first vice president be approved by the Board of Governors.

Federal Reserve operations are not influenced by the profit motive, so that earnings are an incidental result of policies aimed at influencing the volume and cost of the money supply. The Federal Reserve customarily pays to the Treasury nine-tenths of its earnings above expenses and dividends to member banks. The remaining one-tenth is added to the surplus of the Reserve Banks.

Board of Governors

The Board of Governors of the Federal Reserve System has seven members appointed by the President and confirmed by the Senate. Board members give their full time to the business of the Board of Governors. Appointments are for fourteen years, so arranged that one expires every two years. The Board supervises the operations of the Federal Reserve System. The importance of the Board in formulating credit policy of the Federal Reserve System is obvious from the following:

1. It establishes the reserve requirements of member banks.
2. It reviews and determines the discount rates established by directors of the Reserve Banks.
3. Board members are on the Federal Open Market Committee described below; they are a majority of that body.
4. It sets maximum rates of interest that member banks may pay on savings and other time deposits.
5. It is responsible for setting margin requirements for stock-market credit.

Federal Open Market Committee

Seven members of the Board of Governors and five representatives elected by the Reserve Banks constitute the Open Market Committee. This Committee decides on changes to be made in the System's portfolio of Government securities; in other words, when, how much, and under what conditions to buy or sell in the market. Reserve Banks are required by law to carry out these decisions. Committee decisions are influenced by national and regional considerations. Purchases and sales of securities for the System open-market account are divided among the twelve Reserve Banks in accordance with the relative asset size of each.

Federal Advisory Council

This twelve-member body confers with the Board of Governors on business conditions and makes recommendations regarding the affairs of the System. One member of the Committee is selected annually by the board of directors of each Reserve Bank.

Federal Deposit Insurance Corporation

The Federal Deposit Insurance Corporation protects smaller depositors of insured banks against loss. The most important ways it does this are as follows:

1. Insured banks must measure up to FDIC standards.
2. It regularly examines insured banks to make sure that these standards are maintained.
3. When despite precautions an insured bank is in trouble, the FDIC provides the cash to protect depositors.

All member banks of the Federal Reserve System are required to participate in the FDIC plan. Non-member state banks and mutual savings banks may get this insurance if they meet FDIC standards. In 1952, about 93 per cent of all banks, holding 96 per cent of the deposits, were insured by FDIC. It does not cover all deposits in insured banks, however. Just the first \$10,000 of each deposit account is insured; so that in 1952 about 54 per cent of the dollar total of deposits in insured banks was covered.

Insured banks pay to the FDIC an assessment of one-twelfth of 1 per cent of their yearly deposit liabilities. In years when FDIC income exceeds expenses, refunds are made to insured banks. The surplus of the FDIC is invested and also provides funds for its operations. In case additional funds are needed, the United States Treasury is directed to lend the Corporation as much as \$3 billion.

The FDIC does not have to wait until an insured bank is closed before taking action. It may lend to a distressed bank, purchase assets from it, or deposit with it to keep it from failing. Also, it may make loans or purchase assets to bring about a merger or consolidation with a stronger insured bank in the same area. Generally, these actions are taken if the FDIC determines the operations of the bank are necessary to

the community or that such action will reduce FDIC losses. It should be noted that when the FDIC chooses to act to prevent a bank failure it is, in effect, protecting all deposits.

When the FDIC allows an insured bank to close, it customarily pays each depositor's claim up to \$10,000. It may, however, open a new bank and make deposit accounts up to \$10,000 available to those who held insured deposits in the closed bank. All demand and time or savings deposits are insured by the FDIC. But an individual cannot increase the insurance by placing his deposits in two or more types of deposit accounts in the same bank. In other words, all deposits maintained in the same right and capacity are insured to \$10,000. Accounts maintained in different rights and capacities, however, are each insured to \$10,000.

The Federal Deposit Insurance Corporation is managed by a three-man board of directors. They appoint all officers and employees of the Corporation and determine policy. One of the directors is the Comptroller of the Currency; the other two are appointed by the President, with the advice and consent of the Senate. The appointed members hold office for six years, and one is Chairman of the Board. The three members may not all be of the same political party. None of the three may hold any office or be employed by an insured bank while serving on the Board of the FDIC.