



3

CHAPTER

The Federal Reserve System

3.1	Structure of the Federal Reserve System
3.2	Monetary and Fiscal Policy
3.3	Consumer Protection
3.4	Role in Determining Banks' Financial Health
3.5	International Banking and the Federal Reserve System



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skills that pay dividends

Understanding Public Policy and Its Impact on Business

Money flows through the economy. It allows people to trade products and services at a fair value. With money as a medium of exchange, products and services can be exchanged directly between individuals, businesses, and governments without the intervention of third parties.

Government exists to protect people from each other, to protect people from private interests, and to further the ideas that society holds valuable. Government also provides the legal framework to ensure that protections are provided in an organized way. Through legal requirements, the government mandates accountability. Individuals and corporations are legally responsible for their actions and they are required to comply with existing laws.

It is important to understand how these concepts intersect to achieve the goal of economic stability in a thriving society. One example of government policy impacting business is energy conservation. Increased public concern over the condition of the environment and the impact of global warming has been steadily gaining momentum.

In 1992, the Environmental Protection Agency (EPA) began a program called Energy Star, which is a voluntary labeling program. Products that are energy efficient and reduce the emission of greenhouse gases can earn an Energy Star rating.

In 1996, the United States Department of Energy (DOE) entered into a joint partnership with the EPA for the Energy Star program. This joint effort resulted in a substantial increase in the number of products that are eligible for an Energy Star rating.

In 2007, it was estimated that households using Energy Star products could save about 30% on their annual utility bills. Nationally, this represents a savings of \$16 billion on consumers' utility bills.

Another method of promoting energy conservation is through tax incentives. Hybrid vehicles, which are powered by both batteries and fuel, achieve higher fuel efficiency and lower emissions than standard vehicles. To encourage consumers to begin using hybrid vehicles, the government developed an Alternative Motor Vehicle Credit.

This credit is structured to jump start purchases of hybrid vehicles by providing the largest amount of credit to consumers who purchase the vehicles closest to their release dates. The tax credit allows consumers to reduce the amount of federal tax owed by the amount of the credit.

The money consumers save through utility bill reductions and tax credits is money they have available to spend or invest. Government policies, which reflect the goals of the voting public, are designed to influence consumer behavior through financial incentives.

When government policy subsidizes an industry, as is the case for hybrid vehicles, it is impacting the growth and development of the industry. If consumers are eager to help the environment and receive a tax credit, they will purchase hybrid vehicles. This increases demand for hybrid vehicles and encourages more companies to manufacture hybrid vehicles.



Develop Your Skill

Research the tax incentives homeowners with mortgages receive. Determine whether mortgage tax credits subsidize the real estate market.



3.1

goals

- + Identify the organization of the Federal Reserve System.
- + Explain how the Federal Reserve influences banks and the economy.
- + Describe proposed reorganization of the Fed.

terms

- + member bank
- + District Reserve Bank

Structure of the Federal Reserve System

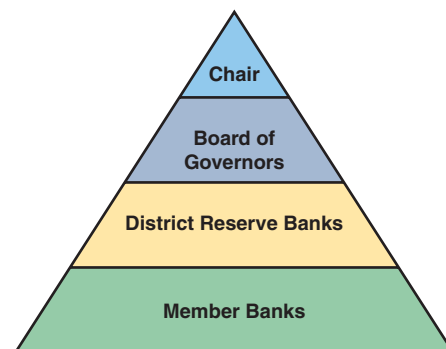
Banking Scene

After opening an account at People's State Bank, Kareema stopped at a fast food drive-thru for a soft drink. Waiting to pay, she happened to glance at the bill in her hand. At the top of her bill, she saw the words "Federal Reserve Note." Why, she wondered, are these bills called Federal Reserve notes? Kareema resolved to find out more about the Federal Reserve System. Where might she start?

STRUCTURE OF THE FED • • • • •

The Federal Reserve was created in 1913 to respond to problems with the nation's changing money supply. Now you will look more closely at the modern Federal Reserve System, learn who makes it up, what the system does, and how it does it. The "Fed," as it is often called, functions as the government's banker, providing a range of financial services both to the government and to all financial institutions. It also supervises banks, conducting examinations to identify risk or bookkeeping problems. The Federal Reserve manages monetary policy as well, hoping to benefit not only banks but also the economy at large.

The Federal Reserve is a uniquely American approach to central banking. It is a combination of public and private policymakers working together to control the nation's monetary policy, supervise banks, and provide financial services to the government and banks. The Federal Reserve is set up like a private corporation, with member banks holding stock in their District Reserve Bank. The President of the United States nominates candidates for the Board of Governors. The U.S. Senate confirms nominees. Congress compromised on a mix of private and public interests for the Federal Reserve, and that mix is intended to serve the interests of the nation at large. The Federal government appropriates no money for the Federal Reserve. Its income is derived from financial services and interest on loans to its member banks. Any money made



above the cost of providing services is turned over to the U.S. Treasury. Think of the structure of the Federal Reserve as a pyramid, with member banks as the base, District Reserve Banks in the middle, the Board of Governors near the top, and the Chairman at the very peak. Each of these levels depends upon information and action from other parts to hold up the system.

Member Banks

Any bank that is part of the Federal Reserve System is known as a **member bank**. All national banks must be member banks of the Federal Reserve System. They must purchase stock in the District Reserve Banks in their regions. This stock cannot be bought or sold, and it does not offer control of the District Reserve Bank. It does convey voting rights, however, for directors of the District Bank, and it also pays a 6 percent dividend. State-chartered banks are not required to be members of the Federal Reserve System, although they may choose to do so if they meet requirements. Investment banks are currently not required to be member banks.

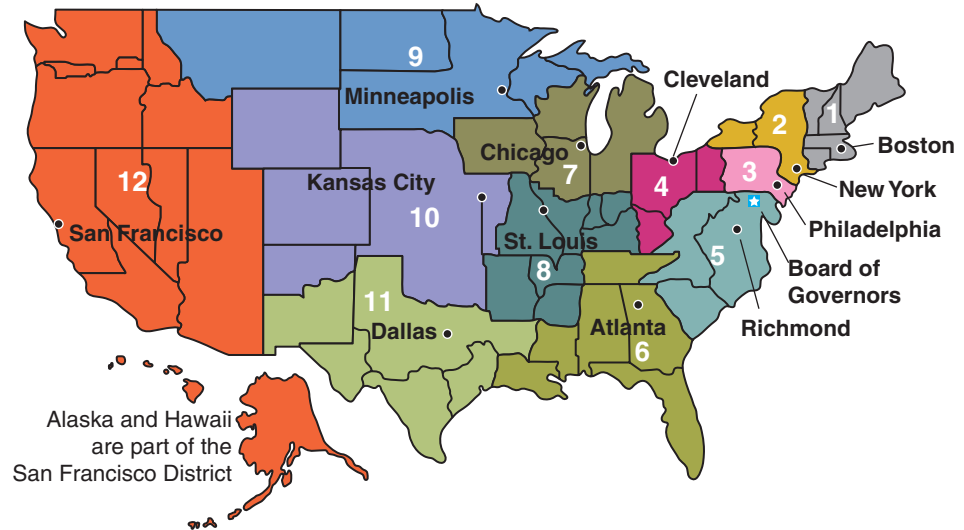
District Reserve Banks

District Reserve Banks carry out banking functions for government offices in their area, examine member banks in the district, decide whether to loan banks funds, recommend interest rates, and implement policy decisions of the Board of Governors. There are twelve regional District Reserve Banks, located in Atlanta, Boston, Chicago, Cleveland, Dallas, Kansas City, Minneapolis, New York, Philadelphia, Richmond, San Francisco, and St. Louis. As of October 2007, there were 25 branch offices supporting the regional offices. The district and regional branches are shown at the right.

Each district bank is governed by a nine-member board of directors, six of whom are nonbankers elected by member banks. The Board of Governors selects the three other board members. Each board also elects the president of its district bank, subject to approval by the Board of Governors.

District Bank	Branch Bank
1. Boston, MA	
2. New York, NY	Buffalo, NY
3. Philadelphia, PA	
4. Cleveland, OH	Cincinnati, OH Pittsburgh, PA
5. Richmond, VA	Baltimore, MD Charlotte, NC
6. Atlanta, GA	Birmingham, AL Jacksonville, FL Miami, FL Nashville, TN New Orleans, LA
7. Chicago, IL	Detroit, MI
8. St. Louis, MO	Little Rock, AR Louisville, KY Memphis, TN
9. Minneapolis, MN	Helena, MT
10. Kansas City, MO	Denver, CO Oklahoma City, OK Omaha, NE
11. Dallas, TX	El Paso, TX Houston, TX San Antonio, TX
12. San Francisco, CA	Los Angeles, CA Portland, OR Salt Lake City, UT Seattle, WA

The Twelve Federal Reserve Districts



The Federal Reserve officially identifies Districts by number and Reserve Bank city.

In the 12th District, the Seattle Branch serves Alaska, and the San Francisco Bank serves Hawaii. The System serves commonwealths and territories as follows: the New York Bank serves the Commonwealth of Puerto Rico and the U.S. Virgin Islands; the San Francisco Bank serves American Samoa, Guam, and the Commonwealth of the Northern Mariana Islands. The Board of Governors revised the branch boundaries of the System in February 1996.

Source: Federal Reserve System

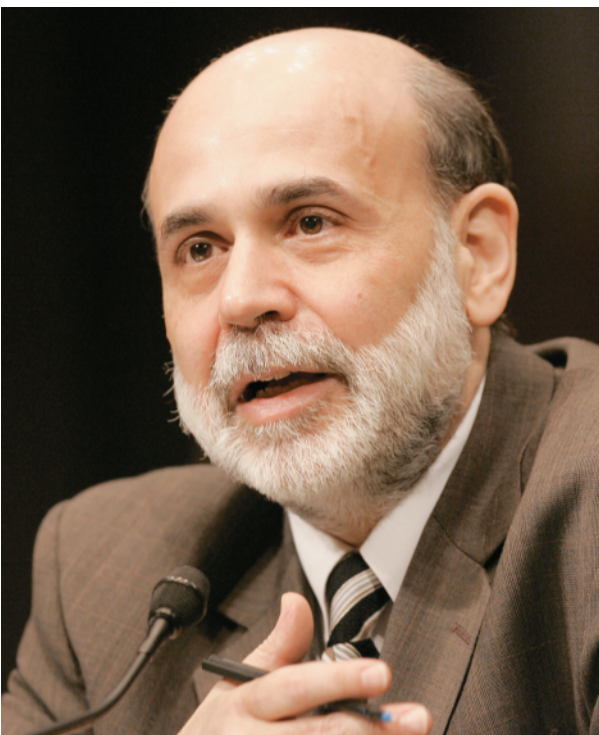
Board of Governors

The President of the United States selects members of the Board of Governors, subject to consent of the Senate. Each of the seven governors

serves a 14-year term, one beginning January 31 of every even-numbered year so that terms are staggered. The Board of Governors is the policy-making arm of the Federal Reserve Board, and its decisions control monetary policy. The Board of Governors oversees the District Reserve Banks and also controls mergers, bank holding companies, U.S. offices of international banks, and the reserves of depository institutions.

The Chair

The President also selects the chair and vice-chair of the Federal Reserve from the membership of the Board of Governors, subject to confirmation of the Senate. The chair and vice-chair each serve a four-year term, but no limit is set on the number of terms. The current chairman, Ben Bernanke, has served since February 2006. The Chair is a visible symbol and powerful spokesperson of Federal Reserve policies.



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interesting facts

The Federal Reserve has actually been making electronic funds transfers since the 1920s, when the telegraph was used to “wire” money. The Fed used telegraph technology until the 1970s. ■

conduct supervisory activities, so that banks, whether members of the Fed or not, are supervised to ensure responsible banking practice. For international banks operating in the United States, the Federal Reserve ensures fair competition and communicates with central banking authorities in other countries to promote consistent policies.

Protecting Consumers

Consumer protection is another function of the Federal Reserve. Bank examiners monitor whether customers are treated fairly in terms of fees, prices, penalties, and even advertising. Banks must show that they offer and perform their services, including making loans, on an equal opportunity basis.

checkpoint

What are the primary functions of the Federal Reserve?

PROPOSED REORGANIZATION OF THE FED ●●●●●●●●●●

The financial crisis which the United States began to experience in the latter half of 2007 helped spur discussion regarding whether the banking regulation system should be reorganized. A number of federal agencies, including the Fed, regulate portions of the banking industry. There is some overlap between agencies and there are some areas not covered by federal oversight. For example, the Fed, the FDIC, the Office of the Comptroller of the Currency and the SEC are all involved in banking regulation. Other agencies are also involved in their regulation.

In response to the need for reorganization, the Treasury Department released a proposed plan for reorganizing the management of domestic financial markets. This plan acknowledged that, given the evolving nature of financial markets and the way that financial institutions overlap in products offered, a new system was required to respond quickly to market needs. For example, as financial institutions routinely sell diverse products covering securities, banking, and insurance, regulation needed to be positioned to manage those areas in a cohesive fashion. Following are some highlights of the report.

President’s Working Group on Financial Markets (PWG) Originally established in 1988, this group was responsible for communicating across agencies to help ensure a healthy stock market that inspired investor confidence. Inter-agency communication was achieved by having leadership representatives from the Treasury, the Fed, the SEC, and the Commodities Futures Trading Commission serve on the PWG committee. In March 2008, the Treasury recommended expanding the PWG committee to include representatives from the Office of the Comptroller of the Currency, the FDIC, and

the Office of Thrift Supervision. This broader-based committee should help achieve the expanded goals of the PWG, including lessening system-wide risk to financial markets, improving the integrity of financial markets, improving protection for consumers and investors, and enhancing the competitiveness of financial markets.

Mortgage Origination Commission (MOC) This proposed commission would be an inter-agency group with responsibility for developing federal legislation requiring states to develop consistent licensing and training requirements for participants in the mortgage industry. Also, states would have a way to enforce federal laws for mortgage originators that are not part of a regulated financial institution. (Independent mortgage originators developed a majority of the subprime mortgage loans.)

Payment and Settlement Systems Oversight Used to transfer funds between businesses, financial institutions, and consumers, the payment and settlement systems help lubricate the economy by making sure money is accurately sent and received. The proposed revisions would include a uniform method for regulating these systems.

Insurance Historically operated under state regulation, the proposed plan recommends establishing an organization to federally regulate insurance providers who opt in to the federal program. Federal oversight would help meet the needs of companies that provide insurance on either a national or international basis.

Futures and Securities Separating the regulation of futures and securities, which made sense in the 1930s when the regulations were established, does not make sense in today's market. As products and markets have converged and as international trading has increased, there is a need to regulate futures and securities together. To achieve this objective, the proposal recommends merging the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). One regulatory body would provide a more agile response to the changing needs of the marketplace.

As this report was first released in March 2008, and as the report in its entirety recommends a multitude of changes that cut across many federal, state, and private entities, it will be some time before the recommendations can be considered and acted upon.



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✓ checkpoint

Why is consideration of reorganizing the Fed such a complicated task?

assessment 3.1

Think Critically

1. Why do you think only national banks are required to be members of the Federal Reserve System?

2. Why are Federal Reserve District Banks distributed across the nation?

3. Why did the Treasury Department feel the need to initiate reorganization of the management of domestic financial markets?

4. List five areas of economic management that are facing possible reorganization based on the Treasury Department's recommendations.

Make Academic Connections

5. **EDUCATION** Visit the Federal Reserve Board of Governors' website at www.federalreserve.gov. From the Site Map link, find the District Reserve Bank that serves your area. Find and visit that bank's site, and discover what materials it makes available for citizen education. List those resources here.

6. **BIOGRAPHY** One of the most influential Federal Reserve chairs in recent history has been Alan Greenspan. Use resource material of your own choosing, and write a one-page report on the life and career of this powerful figure. Include reflections on his comments in the fall of 2008 when he acknowledged that relying on the "self-interest of lending institutions" to behave in a way that made businesses self-sustaining was a gross miscalculation and contributed to the 2008 financial crises.

3.2

goals

- + Explain how the Fed impacts monetary policy.
- + Identify how fiscal policy affects the economy.
- + Explore criticisms of monetary and fiscal policy.

terms

- + Federal Open Market Committee (FOMC)
- + Taylor rule
- + adverse feedback loop

The most famous function of the Federal Reserve is conducting monetary policy. The goals of the Federal Reserve's monetary policy are to maintain economic growth, to stabilize prices, and to keep international payments flowing smoothly. Federal Reserve actions affect the amount of reserves banks hold, as well as the money supply, which in turn affects the economy.

Open Market Operations The Fed buys and sells securities issued by the Treasury Department or other government agencies. These are called *open market* sales because the Fed does not control with whom it is doing business in the sales, but trades at a profit or loss in order to accomplish monetary control. These transactions affect the *federal funds rate*, the rate at which banks borrow from each other. When the Fed wants to increase reserves, it buys securities. When it wants to decrease reserves, it sells them. Although this is the most powerful tool of the Fed, these adjustments are short-term and may take place within either days or hours.

Primary Dealers There is a select group of 20 dealers that the Fed works with to buy and sell securities. These primary dealers must be either broker-dealers that are registered with the SEC or commercial banks that are regulated by supervisors of federal banks. To qualify as a primary dealer, certain capital standards must be met and a certain volume of business must be maintained. Primary dealers engage in a competitive bidding process each time new securities are offered on the open market.

interesting facts

The Council of Economic Advisers analyzes and interprets economic developments. It recommends to the President of the United States national economic policy to promote employment, production, and purchasing power. ■

Setting Reserve Requirements The Fed adjusts the portion of total deposits that banks must keep on hand in their vaults or at the Federal Reserve. Higher reserve requirements result in less money in circulation. Reserve requirement changes are the least frequently used monetary tool of the Fed because changing the reserve requirements fundamentally affects the operations of banks.

Adjusting the Discount Interest Rate The Fed indirectly affects interest rates at large. The *discount rate* is the rate of interest that the Federal Reserve charges banks for short-term loans. Other interest rates often rise or fall with the discount rate. The **Federal Open Market Committee (FOMC)** makes discount rate decisions. The committee consists of the seven-member Board of Governors (which includes the Chairman of the Federal Reserve), the Chairman of the New York District Reserve Bank, and presidents of four other District Reserve Banks who serve on a rotating basis. Although legally required to meet four times annually, the FOMC generally meets about eight times per year. Policy changes, when needed, are decided during the meetings.

The Federal Reserve determines necessary interest rate changes in response to economic conditions. A staff compiles and analyzes large amounts of data for support. Economics is an inexact science. The Federal Reserve had avoided the catastrophes of the 1930s until 2008. As a result of the financial crises of 2008, challenges abound for the Fed and other financial regulatory agencies.

Adjusting Monetary Policy

Tinkering with monetary policy does not occur in a vacuum. FOMC members provide input, through discussion and votes on actions. The market then responds to FOMC actions. During early 2008, market observers had hoped the Fed would cut interest rates by one percent. They thought a one percent cut would help keep inflation at bay. However, the Fed decided to cut rates by three quarters of a percent. (Combined with prior interest rate reductions, this cut led to a two percent rate cut in a two-month period.)

Illustrating that setting monetary policy is not an exact science, two members of the FOMC voted against the three quarter percent interest rate reduction. Even experts do not always agree on the most effective course of action. The three quarter percent rate cut was enough, in the short term, to help improve stock market performance and to improve the international value of the dollar. In essence, the markets gained confidence and responded favorably to the Fed's efforts to help stabilize the economy through interest rate reductions. Adjusting interest rates is one of the many components of monetary policy. Predicting the impact of these adjustments is not straightforward.

Developing Monetary Policy

Did you ever consider all the parties who review, analyze, and try to predict the overall state of the economy? In addition to government staffers and

investors, college professors also are interested not only in the economy's performance, but in what drives that performance.

A Stanford University professor, John Taylor, published the Taylor rule in 1993. In simplified terms, the **Taylor rule** provides ideas for how to use short-term interest rates to achieve the goals of a central bank. These goals include keeping the economy stable and controlling inflation.

The Taylor rule recommends looking at how the economy is performing relative to three targeted indicators. Inflation, full employment, and short-term interest rates are the indicators. When inflation is high or when the economy is above its targeted full employment rate, the Taylor rule suggests that having a high interest rate, which in turn would decrease the money supply, is a good mechanism for restoring the economy to its targeted levels.

The rule provides a simplified method for assessing and forming monetary policy. Although the rule has some limitations, including not being comprehensive enough to capture the essence of a complex economy and not being able to incorporate decisions that might be made to manage specific risks, it is often included as part of the analytical and decision-making process of those who set monetary policy.

New Tools to Manage Monetary Policy

In order to help combat the financial crisis that began to appear in the economy during the summer of 2007, the Fed developed three new tools to help manage monetary policy. Term Auction Facility (TAF), Term Securities Lending Facility (TSLF), and Primary Dealer Credit Facility (PDCF) are the new tools.

There are a number of factors that set these tools apart from each other. The fees charged to the borrower for using the tools, how long the loan will last, the type of financial institution that can use the loan, and the type of collateral that can be used to secure the loan all contribute to the differences between the loans.

- **Term Auction Facility (TAF)** Commercial banks can borrow money from the Fed for a maximum of 28 days. Types of collateral for these loans can vary.
- **Term Securities Lending Facility (TSLF)** Treasury securities can be borrowed by primary dealers. The loans, which last up to 28 days, can be secured by a broader range of collateral than TAF loans.
- **Primary Dealer Credit Facility (PDCF)** Primary dealers can take out loans for up to 120 days. A larger group securities than the TSLF securities will be accepted as collateral.

To avoid having these loans increase the total amount of money in the economy, each time the Fed issues one of these loans, the Fed sells an equal amount of Treasury securities. The TSLF and PDCF were initially planned as short-term measures.

checkpoint

Why is it hard to predict the impact of monetary policy adjustments?

FISCAL POLICY • • • • •

Just as the Federal Reserve System dominates monetary policy, Congress and the President control fiscal policy and are considered co-equal with the Fed in economic decision making. Congress and the President attempt to smooth economic ups and downs by manipulating the federal budget to create enough demand for goods to keep people working but not so much as to cause inflation. This process controls the total demand for goods and services by managing government spending and the amount of taxes collected. This economic management is called fiscal policy. Administered independently of the Fed's monetary policy, fiscal policy involves adjusting budgetary deficits or surpluses to achieve desired economic goals.

“Priming the Pump” in an Economic Downturn When the economy experiences high unemployment and little or no business growth, the federal government attempts to add jobs and stimulate business by “priming the pump,” or cutting taxes. Theoretically, doing so gives businesses and individuals more money to spend, which results in increased demand for goods and services. Expanded demand causes industries to manufacture more products, hire additional employees, and invest in new buildings and equipment. The expansion thus stimulates the economy. This policy is often referred to as *Keynesian economics* for John Maynard Keynes, who is credited with developing it to address the economic crisis during the Great Depression.

In addition to cutting taxes, which impacts workers' current and future paychecks, sometimes the government issues tax rebates. In effect, rebates provide a retroactive reduction in the level of taxation. They provide a partial refund on previously paid taxes.

During the second quarter of 2008, U.S. the government started issuing tax rebates. By using the rebates to pump \$168 billion into the economy, the government hoped to stimulate the slow U.S. economy.

According to economists, tax rebates do not always provide the anticipated stimulus. While studying the affects of a 2001 tax rebate, which ranged in value from \$300 to \$600, Matthew D. Shapiro and Joel Slemrod, both University of Michigan economists, concluded that only about 20 percent of people spent their rebates on new purchases. A majority of taxpayers either put their rebate money into savings or used it to pay off debt.

Slowing the Boom Economy In contrast, when the economy is prosperous, demand can exceed supply. This causes prices to increase and, unless

stopped, leads to *inflation* when rising prices decrease the value of money. When this happens, the government uses the opposite policy. It cuts spending, raises taxes, or uses a combination of the two. As a result, consumers and businesses have less money to spend, reducing demand and stabilizing prices.

✓ checkpoint

Explain Keynesian economics.

CRITICISM OF MONETARY AND FISCAL POLICIES • • • • •

Both monetary and fiscal policies have their critics. The two policies often work at cross-purposes. In general, monetary policies seek to control inflation and tolerate relatively high unemployment to achieve their goal. In contrast, fiscal policy appeals to politicians who want to keep the economy vigorous and growing even at the cost of moderately higher prices.

Monetary policy is relatively more agile than fiscal policy. It is easier for the Fed to change bank reserve requirements than to go through the fairly cumbersome process of changing legislation to alter taxes. It is quicker for the Fed to adjust the amount of money flowing into the economy, by buying or selling dollars on the open market, than altering the level of taxes.



branching out

Skip the Bank, Come to the Store

Retailers were licking their chops hoping to feast on the tax rebate checks that the U.S. government began to distribute during April 2008. The checks were part of a \$168 billion dollar economic stimulus package. In an effort to capture the entire rebate check from as many customers as possible, retailers developed a variety of incentives. A number of grocery chains offered a 10% bonus for rebate checks used to buy gift cards—therefore a \$600 rebate check could be redeemed for \$660 of groceries. Some department and clothing stores offered similar bonuses. One electronics retailer, happy to

settle for a portion of the rebate check, required that a portion of the check be used for a purchase at its store. It would then load the remaining balance onto a prepaid credit card that could be used at other retailers.

Think Critically Is it ethical for retailers to try to get consumers to tie up their stimulus checks with just one store? How would being obligated to spend a large portion of a rebate check at just one store impact the speed with which the stimulus is felt in the economy?



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Monetary policy has a downside. If the flow of cash into the economy is too severely restricted, consumers and businesses cannot afford to borrow. This results in a decline in spending and investments, leading to a failure to sell products—especially “big ticket” items such as new homes, automobiles, and appliances. Factories close. As the economy cools off, more and more workers are laid off, and the downward plunge picks up momentum. This cycle is often called an **adverse feedback loop**.

A recent adverse feedback loop began to occur during the fourth quarter of 2007. By the end of that year, about 8 percent of home loans were either late in payments or in the midst of foreclosure. Some banks wanted to have a smaller portion of their assets tied up in home mortgages. Because the market was unstable and so many home loans were in default, banks began to ask for larger down payments. They also began to cut way back on home equity loans.

With less money available to spend, consumers began to change their consumption patterns. Buying habits at the grocery store changed. Instead of buying convenient, single-serve packages, they bought in bulk. Entrees shifted from expensive meats to less expensive pastas. Other buying patterns also shifted. Instead of buying designer clothing, store brands were bought. In lieu of going out to the movies, DVDs were rented.

Although consumers who are caught in an adverse feedback loop may continue to meet their basic needs, they do so in the least expensive way possible. This reduces the total amount of money flowing through the economy.

Fiscal policy has created deep misgivings and endless controversy. Many economists doubt that the Federal government can regulate the economy by raising or lowering taxes and expenditures. In addition to being clumsy and time-consuming, these methods involve enormous uncertainties. Fiscal policy is especially difficult to use for stabilization because of the gap between the recognition of its need and its implementation by the President and Congress. For example, the tax cut proposed by President John F. Kennedy in 1962 to stimulate the economy was not legislated until 1964.

Both policies are based on predictions. Even made by experienced economists, predictions are just that—forecasts of what *could* happen.

✓ checkpoint

What is an adverse feedback loop?

assessment 3.2

Think Critically

1. How does increasing a bank's required reserve result in less money circulating in the economy?

2. Why doesn't the government legislate the value of money and set interest rates by law?

3. Explain the Taylor rule.

4. List and define three new tools for managing monetary policy.

Make Academic Connections

5. **PREFERRED VENDORS** The website of the Federal Reserve Bank of New York lists current primary dealers. Review the list and determine whether the status of any primary dealers has been or will be impacted by changes that have occurred in overall market conditions. List your thoughts below.

6. **RESEARCH** A tax rebate was issued in April 2008. Go online to research the effect of the rebate on the economy. Be prepared to discuss with the class whether you believe rebates are an effective stimulus tool.



3.3

goals

- + Explain the various acts that protect consumer rights.
- + Understand how enforcement responsibilities are shared across agencies.

terms

- + Truth in Lending Act (TILA)
- + Equal Credit Opportunity Act (ECOA)
- + Fair Credit Reporting Act (FCRA)
- + Fair Debt Collection Practices Act (FDCPA)
- + Government Accountability Office (GAO)

Consumer Protection

Banking Scene

Kareema decided to open a new credit card to take advantage of the customer reward program at her favorite clothing store. She was shocked to see all the forms and all the fine print she had to read and sign off on before getting a credit card. There was a lot of discussion regarding interest rates and finance charges. Kareema wondered why there was so much information on the forms. Who decides what information should be included on the forms? Where can she get help to understand what's on the forms?

CREDIT TRANSACTION PROTECTION • • • • •

An important role of the Fed is to protect consumers. This protection is ensured when the Fed establishes and enforces regulations that promote fairness in the treatment of consumers by private businesses. Financial transactions of consumers are usually protected by consumer protection laws. Protected credit transactions run the gamut from debit cards, car leases, and mortgage loans to ATM transactions.

Credit policies are not always easy to understand. In the past lenders sometimes made it purposefully difficult. In a wave of consumer protection legislation during the 1960s, '70s, and '80s, Congress enacted several important laws to guarantee the rights of consumers. These disclosure laws require that details of lending agreements be specified in writing. Other important laws require far more than disclosure, guaranteeing equal access to credit for qualified consumers, accurate credit reporting, and freedom from unfair or deceitful collection practices. Banks are required not only to conform to federal and state laws, but also to document their compliance.

Truth in Lending

Credit cards are the most common form of open-end credit account that are not secured by a home. The **Truth in Lending Act (TILA)**, Title I of the Consumer Credit Protection Act of 1968, was landmark legislation. Amended many times, it guarantees that all information about costs of a loan is provided in writing to consumers. Items that must be disclosed include the following.

- Total sales price
- Amount financed
- Annual percentage rate (APR)
- Variable rate information
- Total payments
- Schedule of payments
- Prepayment policies
- Late payment policies
- Security interest

In addition, the act provides for a right of rescission, which allows a consumer to change his or her mind about a loan until midnight of the third business day following the signing of papers. The law also prescribes complaint procedures and penalties.

Legislation to update TILA was pending as of May 2008. These pending amendments involve ensuring that interest rate increases, discounted promotional rates, and all payments are applied fairly.

Equal Credit Opportunity Act

The **Equal Credit Opportunity Act (ECOA)** prohibits the use of race, color, religion, national origin, marital status, age, receipt of public assistance, or exercise of any consumer right against a lender as a factor in determining creditworthiness. If a credit request is denied, the law also requires that the lender provide the reasons for the denial upon request.

Fair Credit Reporting Act

The **Fair Credit Reporting Act (FCRA)** aims to protect the information that credit bureaus, medical information companies, and tenant screening services may collect. First enacted in 1971, the legislation provided the first legal oversight of the credit information industry. The FCRA establishes the following rights, some of which were added in 2003.

- Consumers must be told what is in their file and who has had access to the information.
- Consumers must be told if information in their file has been used against them.
- Consumers can dispute inaccurate information in their reports. The agency must investigate disputes within 30 days.



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Tax incentives influence consumer behavior in support of government objectives. Access www.cengage.com/school/pfinance/banking and click on the link for Chapter 3. Visit the IRS website to learn about hybrid cars and alternative fuel vehicles. Review the current status of hybrid vehicle tax credits. Would the stated tax credit influence your decision about what type of car to purchase? Why or why not?

www.cengage.com/school/pfinance/banking

- Inaccurate information must be corrected or deleted.
- Credit bureaus cannot report information more than seven years old in most cases, or more than ten for bankruptcies.
- Access to consumer files is limited.
- Consumers must authorize the release of reports to employers.
- Lenders cannot obtain medical history or use medical history to determine a credit applicant's worthiness of obtaining a loan.
- Consumers can seek damages for violations of the law.
- By standardizing the information included on credit reports, bias is removed from the reports. These unbiased credit reports enable a broader spectrum of consumers to receive credit.

Legislation to update FCRA was pending as of 2008. A summary of these pending amendments follow.

- A company cannot share customer contact information with its affiliates unless the consumer is offered an easy way to opt out of the solicitation. This rule has been finalized.
- All businesses that hold a consumer account must develop an identity theft prevention program to proactively thwart attempted identity theft.
- *Risk-based pricing* is when a business offers less favorable credit terms to a consumer with a relatively weaker credit score. This proposal would require businesses that use risk-based pricing to provide a risk-based pricing notice to the consumer before the consumer commits to the transaction.

Fair Debt Collection Practices Act

The **Fair Debt Collection Practices Act (FDCPA)** protects consumers from unfair collection techniques. Third-party collectors may not use deceptive or abusive tactics as they try to collect overdue bills. Such collectors may not contact debtors at odd hours, call repeatedly or in a harrasing manner, or threaten them in any way, even with legal action, unless it is actually contemplated. Nor may collectors reveal the debts or collection actions to other people, such as employers, in an attempt to embarrass the debtor. Penalties are prescribed for violations of the act.

✓ checkpoint

Name four important pieces of consumer protection legislation.

OTHER LEGISLATION • • • • •

The preceding four laws are the foundation of consumer protection, but there are many other laws that apply as well.

- **Fair Credit Billing Act** An amendment of TILA, it specifies fair procedures for resolving billing disputes and prevents creditors from taking adverse action until the dispute is resolved.

Ethics in Action

FCRA, like many consumer protection laws, focuses on privacy rights of individuals. Privacy rights are an inherent part of the American psyche. The 2001 Patriot Act, enacted as a way to help combat the potential financing of terrorism, put into effect a number of policies that enabled government agencies to obtain personal financial information about citizens. By issuing requests either through the Foreign Intelligence Surveillance Act (FISA) or through national security letters (NSLs), government agencies are authorized to obtain this personal financial information without the knowledge of affected citizens. The financial institutions providing the financial information to the government are prohibited from revealing the requests to affected account holders. Although the Patriot Act was reauthorized by Congress in 2006, certain provisions to the Act are being challenged in court. The premise of the challenges is whether the First Amendment rights of citizens are being unlawfully violated. Litigation on this issue is pending.

Think Critically

Is it ethical for the government to obtain confidential information about citizens without the knowledge of citizens? When do national security concerns supersede individual privacy rights? How should oversight of government agencies occur in this situation?



- **Fair Credit and Charge Card Disclosure Act** Also an amendment of TILA, it requires credit and charge card issuers to provide information about open-end credit in direct mail or telephone solicitations. Credit card issuers must advise consumers of all fees prior to assessing the fees.
- **Home Equity Loan Consumer Protection Act** Also amending TILA, it requires lenders to make appropriate disclosures about open-end loans that are secured by homes and places limitations on such plans.
- **Credit Repair Organization Act** Prohibits credit repair companies from misleading consumers about their services and costs and requires agreements to be in writing.
- **Gramm-Leach-Bliley Act** Compels banks and other financial institutions to protect the privacy of consumers. Institutions must develop written policies, notify consumers of them, and allow consumers the opportunity to “opt out” before a bank can sell some forms of personal information to others.

In addition to these federal regulations, many states have enacted similar laws intended to protect the rights and privacy of consumers.

Housing and Real Estate

A number of acts have been passed to ensure consumer protection in real estate and housing. These acts include the Flood Disaster Protection Act of 1973, the Real Estate Settlement Procedures Act of 1974, the Home Equity Loan Consumer Protection Act of 1988, and the Home Ownership and Equity Protection Act of 1994. Requiring flood insurance for designated areas, mandating that real estate settlement costs be disclosed to consumers, and protecting against exploitative real estate lending practices are protections provided under these acts. Lenders are also required to clearly list all terms for home equity loans and to limit rates and fees on home equity loans.

Educating the Public on Their Rights

The Fed offers a variety of brochures on its website aimed at educating consumers, in easily understandable language, about their rights. The brochures span topics from shopping for a mortgage, identity theft protection, and understanding credit scoring to information on leasing a car. To serve as broad an audience as possible, and to keep pace with the changing demographics in the U.S., many of these brochures are also offered in Spanish.



Name three other pieces of lending legislation.

ENFORCEMENT OF POLICIES OUTLINED IN ACTS • • • • •

Authority for enforcing consumer protection acts varies with the individual law and the government agency associated with it.

Shared Responsibilities

In addition to the Federal Reserve Board, agencies that share enforcement responsibilities include the Federal Deposit Insurance Agency (FDIC), the Securities and Exchange Commission (SEC), the Office of Thrift Supervision (OTS), the Federal Trade Commission (FTC), the National Credit Union Administration (NCUA), the Office of the Comptroller of Currency (OCC), and the Commodity and Futures Trading Commission. These agencies have specific areas of responsibility and work together jointly on various aspects of enforcement.

In addition, audits are conducted to test compliance at banks and other financial institutions. Examiners typically review randomly selected loan files for completeness of documentation. They also watch for patterns of credit granting and denial, look at the way disputes are resolved, and check to see that privacy regulations are being observed.

One such audit was conducted in January 2008 by the **Government Accountability Office (GAO)**. The GAO is the auditing arm of Congress that helps ensure that federal laws and policies are implemented properly. The 2008 audit was a comprehensive study of the banking industry's compliance with the fee disclosure requirements of the Fed.

The report indicated that for over 20 percent of the branches included in the survey, it was difficult to easily obtain complete information about account terms and conditions. In response to the issuance of the report, numerous government agencies with oversight and implementation responsibilities have pledged their support to make sure customers can easily obtain all banking fees and terms.



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✓ checkpoint

Why are so many agencies involved in enforcing consumer protection?

assessment 3.3

Think Critically

1. What factors brought consumer protection laws into being?

2. How might incomplete disclosure in an advertisement about a car loan have misled consumers before passage of the Truth in Lending Act? Give an example.

3. Why is it in a bank's best interest to provide complete disclosure in a lending agreement and documentation of compliance with all lending laws?

4. Some bankers feel that the banking industry is overregulated. What probably leads them to feel this way?

Make Academic Connections

5. **COMMUNICATION** Work in teams to conduct a poll of at least 30 people. Find out how many of them have examined their credit reports in the last 12 months. How many of them have been the victim of an erroneous entry in a credit report? How many are aware of key provisions of FCRA?
6. **PROBLEM SOLVING** Conduct research to learn what information you should include in a letter of dispute to a consumer reporting agency. Draft a sample letter to a consumer reporting agency disputing a charge for an unpaid dental bill from a dentist of whom you've never heard.
7. **CONSUMER AFFAIRS** Review the privacy policy of a local bank's website. Report your findings.

Role in Determining Banks' Financial Health

Banking Scene

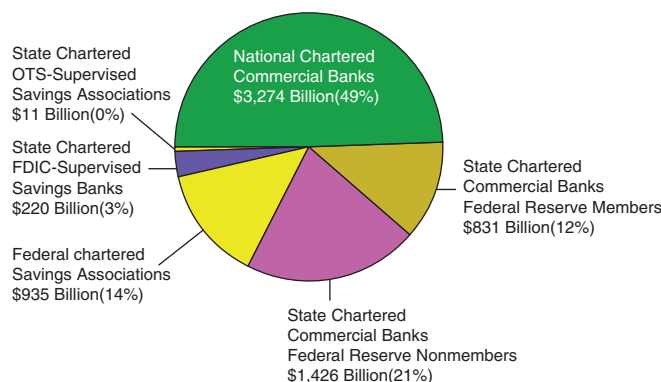
Kareema was visiting her Grandma and they decided to order pizza. Grandma said she was short on cash and was going to run to the bank. One minute later, Grandma reappeared with cash. Puzzled, Kareema asked her how she got to and from the bank so quickly. With a wry smile, Grandma indicated that the “bank” was a secret stash under her mattress. Having lived through the Great Depression and the crash of the banks, Grandma was leery of banks. Kareema wondered how banks stayed secure today. What safeguards are in place to keep banks secure?

OVERSIGHT RESPONSIBILITIES OF THE FED

The banking crisis that began during the second half of 2007 caused many people to be quite concerned with the stability of the nation's financial markets. Indeed, for individuals who have (or had) friends or relatives who lived through the Great Depression of the 1930s, anxiety about the stability of banks may have been heightened.

How does the Fed work to promote the stability of the banking system? Congress gave the Fed the jobs of regulating and supervising the banking system. The Board of Governors writes banking regulations. These regulations provide a blueprint of appropriate business practices for banks.

**Federal Deposit Insurance Corporation
Summary of Deposits
Deposits of FDIC-insured Commercial Banks and Savings Institutions
By Charter Class
As of June 30, 2007**



Excludes U.S. branches of foreign banks and OTS trust institutions that are not required to file the Branch Office Survey
Source: Federal Deposit Insurance Corporation

3.4

goals

- + Explain the regulatory process and how it works.
- + Review how regulations affect the banking business.

terms

- + charter
- + Call report
- + System to Estimate Examinations Ratings (SEER)
- + CAMELS

“communicate”

Two countries an ocean apart took similar steps to rescue failing financial institutions. In 2008, the British government nationalized Northern Rock and the U.S. government took control of Fannie Mae and Freddie Mac. In both instances the rescue occurred because each lender was a significant participant in the mortgage lending market. Research these government rescues and prepare a two-page paper outlining the root causes of the need for the rescue and the impact of government intervention.

Enforcing the rules is the responsibility of the 12 Reserve banks. Enforcement of a variety of financial institutions is required. International corporations that do banking in the U.S., state-chartered member banks, and bank holding companies are under the supervision of Reserve banks.

The Fed has help supervising banks. The FDIC, the OTS, and the OCC also supervise banking institutions. The pie chart on page 81 helps clarify supervisory roles and relative dollar volumes.

The Review Process

The Reserve banks ensure that each bank complies with state and federal legal requirements. They also make sure that each bank adheres to its own internally developed methods for conducting business. Most importantly, the Reserve banks make sure that each bank has sufficient reserves to handle outstanding loans and the risks associated with those loans.

Banks are given permission to operate as a business based on their **charter**, which is a legal approval to operate a business as a bank. Charters are issued by a government authority. The specific agency that issued the charter is responsible for regulating the bank. The table below clarifies some of these relationships.

Supervising Authority	Type of Institution
Federal Reserve	State banks (that have joined the Fed) Bank holding companies
Office of Thrift Supervision	Savings and loan associations Thrift holding companies
Comptroller of the Currency	National banks
Federal Deposit Insurance Corporation	State banks (that have not joined the Fed)

Size and structure of the financial institutions dictate the frequency of on-site reviews. Member banks, which are state banks that have chosen to become members of the Fed, usually receive an on-site review annually. Small banks, with assets of less than \$250 million, might only be reviewed every 18 months. For some state member banks, the Fed may alternate on-site reviews with the overseeing state.

Processes and technologies are in place to streamline the off-site monitoring of banks. Actual reports that banks must complete on a regular basis vary by the size and scope of the bank. Larger banks with more diversified activities are required to complete more reports.

To make sure that bank reports and supervision are performed in a uniform manner, the Federal Financial Institutions Examination Council (FFIEC) was established by Congress in 1978. Membership on the council includes representatives from the Federal Reserve Board of Governors, the Comptroller of the Currency, the National Credit Union Administration, the FDIC, and the OTS. By having members from a variety of agencies, the FFIEC fosters information sharing between state and federal agencies with the common goal of providing consistent methods for banking supervision.

Each quarter, banks are required to complete a Consolidated Reports of Condition and Income, or **Call report**. This report is the basis for the *Uniform Bank Performance Report*. By comparing current financial ratios to past financial ratios, the Uniform Bank Performance Report highlights any

changes in a bank's performance. Declines or startling changes in performance trigger investigation by the supervising agencies.

The **System to Estimate Examinations Ratings (SEER)** is an automated system that analyzes and compares historical supervisory ratings of banks with their Call report data. SEER provides an additional method of capturing changes in financial performance that may require supervisory intervention. SEER data can also be used to track trends within the banking industry.



Why is the authority that issued a bank's charter important in the ongoing operations of the bank?

THE SCORE CARD

After each on-site review is completed, the Fed issues a rating for the bank. Examiners use the **CAMELS** system to evaluate six criteria of safety and soundness. Each letter stands for one of the criteria: Capital adequacy, Asset adequacy, Management, Earnings, Liquidity, and Sensitivity to risk. Risk evaluation measures whether a bank makes good decisions in lending money. CAMELS ratings are not public information. The agency that issues the rating has proprietary rights to the rating. Banks cannot release their CAMELS rating to third parties without first obtaining approval from the agency that issued the rating. This issue became prominent when insurance companies began to ask banks for their CAMELS rating prior to providing them with insurance.

Maintaining Balance in the Banking System

Banks are required to get permission from the Fed before they can acquire another bank, introduce new products, or diversify. This mandatory approval process enables Reserve banks to make sure that regulatory requirements are met. The permission process also gives the Fed an opportunity to ensure there will be sufficient competition in the regional market.

Trust Generates Trust

Remember, it takes a great deal of mutual trust for all parties in an economic system to keep investing in a system. Each investor needs to be assured that every other investor will act within a predefined and universally accepted way. Banking regulations make a code of conduct explicit and mandatory. This gives investors assurance that their money will be carefully and honestly managed. This trust allows money to keep flowing through the system. Regulations can be revised to reflect needs of society and still maintain the safeguards necessary for ethical and safe practices.

Regulations that Encourage Private Investors to Aid Ailing Banks

A variety of privately financed entities, including private equity firms, hedge funds, and mutual funds, were willing to provide capital to distressed banks during the recent mortgage and credit crises. Regulations that were in place during April 2008 allowed these investors access to the banks' books, including some confidential banking records. By being allowed to carefully examine banks' financial status before investing in them, privately financed companies could obtain a solid understanding of actual financial positions of the bank. Knowing what they were getting into allowed private equity firms the ability to negotiate the terms of their investment and to invest with a clear understanding of any risks associated with their investment.

During the savings and loan crisis that occurred during the late 1980s and early 1990s, private investors did not have the same level of open access to the books of banks. This lack of access discouraged private investment firms from providing capital to help save failing savings and loans.

Future Regulations that May Facilitate Private Investment

Some market watchers think the government should make additional regulatory changes to further encourage private equity investors to help save banks.

Current regulations cap the percent that a private equity firm can invest in a bank at less than 10 percent of shares. There is a belief that by increasing that cap, private equity firms would be more willing to invest in banks. An increased percentage of ownership would provide stronger shareholder voting power. With stronger voting power, firms would feel they have more control over future management of the bank.

Another recommended change would impact banking acquisitions. Currently, when one bank acquires another, any bad loans held by the acquiree must be written off immediately by the acquiring bank. This requires a lot of upfront capital from the acquiring banks. Similarly, a large amount of capital for bad debt is a disincentive for many potential investors.

The recommended change would allow bad debt held by the acquiree to be written off over time. This would lessen the amount of capital an acquiring bank would need to provide. By lessening the immediate financial exposure of the acquiring bank, the proposed change would lower the hurdle for acquiring a bank.



Why is society interested in encouraging banks to help other ailing banks?

assessment 3.4

Think Critically

1. What is a charter?

2. What does the acronym CAMELS represent?

3. How does the Uniform Bank Report help regulators?

4. Why is trust necessary in the banking system?

Make Academic Connections

5. **LOCAL REGULATION** Interview a local bank representative and ask about the review process at his or her bank. Find out which regulatory agencies participate in the review and the frequency of the reviews. Inquire how the bank's asset level affects the frequency of the review schedule. Summarize your findings below.

6. **RESEARCH** Copies of Call reports are available to the public at the FFIEC website. Go to cdr.ffiec.gov/public and look up the most recent Call report for your bank. Scan the report to obtain an idea of the completeness of the data collected. Does the thoroughness of the data collected make you, as a consumer, feel more confident that your bank is closely regulated? Be prepared to discuss your thoughts and feelings with the class.



3.5

goals

- + Explain the role of the Fed in international banking.
- + Discuss how the Fed works to keep the dollar strong.
- + Review how countries work together to provide a stable international banking economy.

terms

- + Strength of Support Assessment (SOSA)
- + ROCA score
- + fixed exchange rate
- + flexible exchange rate
- + balance of payments
- + Federal Reserve System Open Market Account (SOMA)
- + U.S. Treasury Exchange Stabilization Fund (ESF)

International Banking and the Federal Reserve System

Banking Scene

Kareema had spent a few years saving money for her upcoming vacation to Europe. She had carefully planned her budget to cover transportation, lodging, food, admittance to attractions, and some spare money for spontaneous “fun” activities. She had recently read that the value of the dollar had declined relative to the euro. She began to worry about her expenses. Realizing the dollar would buy less on her trip, she was examining her budget to see where she could cut back. Why did the dollar weaken?

AN INTERDEPENDENT GLOBAL ECONOMY • • • • •

Globalization has led to increased interdependency between nations. Food, raw materials, medicines, electronics, and vehicles are just a few of the products that flow between borders. Money is required to enable these transactions. A mutually acceptable method needs to be in place so that nations that use different currency can exchange funds across international borders.

Just as products flow across borders, financial instruments flow across borders. U.S. monetary policies affect the global economy just as financial actions of the global economy affect the U.S. economy. Foreign-owned banks operate in the U.S. and U.S.-owned banks have offices in foreign countries. The Fed works, sometimes in conjunction with other U.S. agencies or with central banks of other countries, to promote stability in international financial markets. Efforts include supervising international banking, minimizing disruptions in currency value, and sponsoring internationally focused learning sessions.

Supervision of International Banks

There are multiple ways that the Fed regulates foreign banking. U.S.-chartered banks that operate in foreign countries are regulated by the Fed. Banks that are chartered in a foreign country and transact business in the U.S. are also regulated by the Fed.

Federal Regulation of foreign banks was formalized with the International Banking Act of 1978 (IBA). To ensure a level playing field between international banks and domestic banks, this act gave the same powers to foreign banks that U.S. banks have. On the flip side, foreign banks are subjected to the same restrictions as U.S. banks.

Nearly 20 years later, this act was amended with the passage of the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA). Under FBSEA, foreign banks are required to obtain the approval of the Fed before opening offices in the U.S. In determining whether to approve these applications, the Fed considers how stringently the bank is regulated in its country of origin, the overall financial health of the bank, and whether the bank and its country of origin actively seek to fight money laundering.

Sometimes the Fed partners with other U.S. supervisory agencies to carry out regulations. Two sets of rankings have been established to help with this process. The **Strength of Support Assessment (SOSA)** reflects how well a foreign bank is able to provide appropriate guidance, oversight, and financial backing to its U.S. offices. A composite score of performance in four distinct areas is a **ROCA score**. The areas included in this score are risk management, operational controls, compliance, and asset quality.

Stabilizing Currency Values

Promoting full employment, price stability, and economic growth is the common goal of many monetary authorities in various countries.

Banking Math *Connection*

With a flexible exchange rate, currency values change relative to other currencies. The following chart shows the values of a few currencies relative to the dollar as of August 2008. These rates were listed in the Foreign Exchange Rates section of the Federal Reserve. Find how many euros equal 1 U.S. dollar.



Country	Denomination	\$US August 2008
Australia	dollar	0.8815
EMU members	euro	1.4955
India	rupee	42.9057

Solution

$$\frac{1 \text{ euro}}{1.4955 \$US} = \frac{x \text{ euro}}{1 \$US}$$

$$1.4955x = 1$$

$$x = 1 \div 1.4955$$

$$x = 0.67 \text{ euros}$$

Therefore, 1 \$US will buy 0.67 euros.

Foreign exchange methodologies have changed through the years. From about the mid 1940s until the early 1970s, the U.S. dollar was at the center of international currency exchange. Under a fixed-rate exchange system, the U.S. needed to maintain the dollar price of gold at about \$35 per ounce. The U.S. would buy and sell dollars to stay at or near the \$35 rate. In turn, other countries were required to maintain the value of their currency relative to the U.S. dollar at a set amount. Only a one percent variation in value was allowed.

A **fixed exchange rate** is a bit of an artificial system. A monetary valuation of one country's currency is tied to the valuation of another country's currency. Sometimes the decision is made to maintain the international currency value at the expense of some other monetary goal—like maintaining full employment, price stability, or economic growth.

A **flexible exchange rate** enables currencies to fluctuate based on market conditions. However, to fully understand flexible exchange rates, an understanding of balance of payments is necessary.

Balance of Payments

Countries monitor the total amount of goods and services that leave their country. They also monitor the amount of goods and services that enter their country. Each country looks at the overall total of its imports and exports. It also monitors the amount of goods and services it trades with individual countries. The **balance of payments** is a record of all the exchanges of goods and services that occur between two countries for a specified time period.

A flexible exchange rate allows currency values to move up or down in response to changes in the balance of payments. If Country A sends more goods and services to Country B than it receives from Country B, then Country A has a surplus in the balance of payments with Country B. As a result of this surplus, Country A's exchange rate increases relative to Country B's. Therefore, Country A's currency can buy Country B's goods more cheaply. Likewise, Country B will find it more expensive to buy the goods of Country A.

tech talk



Electronic Funds Transfer

Like many businesses and private individuals, the Federal Reserve System uses electronic funds transfer (EFT) to make and receive payments. The Fed has its own system, called Fedwire, with special capabilities. Fedwire connects the Federal Reserve, the Treasury, other government agencies, and more than 9,500 financial institutions. In 2000, an average of 430,000 daily payments totaling about \$1.5 trillion took place over the Fedwire network. The Federal Reserve by law must charge for its Fedwire services and prices them according to cost.

Think Critically In what ways does Fedwire strengthen the entire Federal Reserve System? Why might the law mandate a charge for this service?

✓ checkpoint

How would a balance of payment deficit affect Countries A and B?

KEEPING THE DOLLAR STRONG • • • • •

In the mid 1970s, the method for managing international currency stability changed to flexible exchange rates in the U.S. The Fed helps maintain the international value of the dollar through foreign currency operations. The FOMC provides guidance to the Fed when it buys or sells U.S. dollars. The goal of stabilizing the international value of the dollar is to maintain a stable currency value to encourage international trade. Countries who wish to conduct business with the U.S. want a clear understanding of the profits and/or risks associated with the trades. Knowing that the value of the dollar will remain relatively stable allows foreign investors to predict the amount of profit or risk they will experience.

How do actions of the Fed stabilize the dollar? If the value of the dollar is falling, the Fed may purchase dollars by selling foreign currency. This tightens the supply of dollars on the open market, which causes the value of the dollar to increase. If the value of the dollar is high and the Fed wants to lower it, the Fed may buy foreign currency with U.S. dollars. This increases the supply of U.S. dollars in the marketplace, which lowers the value of the dollar. The Fed seeks to maintain a steady balance of Federal Reserve balances. When the Fed sells foreign currency, it *sterilizes* the impact of the sale by purchasing an equivalent amount of U.S. currency. Sterilization is necessary to maintain the federal funds rate at the target set by the FOMC. The account the Fed maintains international reserves in is the **Federal Reserve System Open Market Account (SOMA)**. The account the Treasury maintains international reserves in is the **U.S. Treasury Exchange Stabilization Fund (ESF)**.

As the U.S. Treasury and the Fed work in close cooperation on decisions and policies affecting foreign currency issues, they also share responsibility for maintaining the levels of foreign exchange reserves in the U.S. This shared responsibility results in a generally equal division of reserve holdings. For example, at the end of June 2007, the Federal Reserve had nearly \$21 billion dollars in its SOMA account and the Treasury had a nearly equal amount in its ESF account.

✓ checkpoint

Why is the Fed interested in stabilizing the value of the dollar?

INTERNATIONAL COOPERATION • • • • •

Many countries realize their dependence on and vulnerability to international market conditions. In addition to trading products across borders, countries or citizens from one country may directly invest in businesses in another country. One example of this direct investment is when foreign investors purchased mortgage-backed securities during the U.S. mortgage crisis. These investors were hoping to make a profit by purchasing the securities at a discount. By doing this, foreign investors held a significant number of U.S. mortgages.

To foster a spirit of trust, and to develop laws that ensure transactions are carried out in good faith and honestly, a number of organizations have formed over the years that are designed to make banking safe and mutually beneficial across international borders.

International Monetary Fund (IMF) Representatives from 185 member countries work together to promote economic growth among member countries. The IMF takes actions to encourage the stability of the financial exchange markets. Sometimes the IMF will lend money to a country that needs help with its balance of payments. The IMF also seeks to avoid money laundering in an effort to avoid financing terrorism.

Bank for International Settlements (BIS) With about 140 customers, the BIS is a bank for central banks. Serving only countries (and not private entities), it focuses on fostering international monetary and financial stability. A variety of products aimed at helping central banks invest and manage their foreign assets is offered by BIS.

Asia Pacific Economic Cooperation (APEC) The 21 members of APEC are referred to as “member economies.” APEC encourages economic growth in the Asia-Pacific Region. The U.S. is a member of APEC.

International Banking Seminars Since 1997, the Federal Reserve Bank of Chicago has organized international conferences on banking. By bringing together people who develop policy and people who do economic research, the seminars provide a cross section of ideas regarding issues that cut across many aspects of international banking. Recent seminars have focused on “Globalization and Systemic Risk,” “International Financial Instability: Cross Border Banking and National Regulation,” and “Credit Market Turmoil of 2007–2008: Implications for Public Policy.”

checkpoint

How does bringing together policy makers and researchers to examine a common topic facilitate smooth transactions for international banking?

assessment 3.5

Think Critically

1. Explain the key concepts of the International Banking Act of 1978.

2. What does the acronym ROCA mean and how does it relate to SOSA?

3. What is the balance of payments?

4. Name the account for international reserves maintained by the Fed and by the Treasury.

Make Academic Connections

5. **EDUCATION** Visit the website of the Chicago Federal Reserve at www.chicagofed.org/news_and_conferences/conferences_and_events/2008_international.cfm. Review recent seminars on international banking and see what seminars are planned for the future. Be prepared to discuss how the seminars reflect past, current, and future concerns of the industry.

6. **CURRENT EVENTS** During the third quarter of 2007, the international value of the dollar fell. During that time, one euro could buy \$1.4065. Prior to that time, one euro could not buy more than \$1.4. One result of the falling dollar value was that products manufactured in America were less expensive to citizens of countries whose currency was strong relative to the dollar. This increased American exports. Research the current international value of the dollar relative to the euro. List it below. Also list how the dollar's international value affects the overall economy.



chapter 3 assessment

Chapter Summary

3.1 Structure of the Federal Reserve System

- A. The Chair oversees the Federal Reserve Board, which oversees the 12 District Reserve Banks, which monitor and serve the member banks.
- B. The Fed is the U.S. government's bank, a bank for banks, and a supervisory organization.

3.2 Monetary and Fiscal Policy

- A. Monetary policy adjusts bank reserves and influences interest rates for economic stability. The Federal Reserve is the author of monetary policy.
- B. Fiscal policy is the Congress and President's way to control the economy.

3.3 Consumer Protection

- A. Four main laws (TILA, ECOA, FCRA, and FDCPA) provide the foundation for consumer protection in lending.
- B. Banks are required to document their compliance with all applicable state and federal regulations.

3.4 Role in Determining Banks' Financial Health

- A. The Fed, the FDIC, OTS, and OCC share oversight duties.
- B. Quarterly Call reports summarize banks' performance.

3.5 International Banking and the Federal Reserve System

- A. The Fed supervises U.S. banks with offices abroad and foreign banks with offices in the U.S.
- B. The Fed and the Treasury work to keep the dollar strong.
- C. Multiple organizations foster international economic development.

Vocabulary Builder

Choose the term that best fits the definition. Write the letter of the answer in the space provided. Some terms may not be used.

- ___ 1. A report banks are required to complete quarterly that reflects their performance
- ___ 2. A rating of how well a foreign bank is able to provide appropriate guidance, oversight, and financial backing to its U.S. offices
- ___ 3. A record of all the exchanges of goods and services that occur between two countries for a specified time period
- ___ 4. Protects consumers from unfair collection techniques
- ___ 5. Guarantees that all information about a loan is provided in writing
- ___ 6. When the monetary valuation of one country's currency is tied to the valuation of another country's currency
- ___ 7. The government body that makes decisions about discount interest rates
- ___ 8. A theory about using short-term interest rates to achieve the goals of a central bank
- ___ 9. Legal approval to operate a business as a bank

- a. adverse feedback loop
- b. balance of payments
- c. Call report
- d. CAMELS
- e. charter
- f. District Reserve Bank
- g. Equal Credit Opportunity Act (ECOA)
- h. Fair Credit Reporting Act
- i. Fair Debt Collection Practices Act (FDCPA)
- j. Federal Open Market Committee (FOMC)
- k. Federal Reserve System Open Market Account (SOMA)
- l. fixed exchange rate
- m. flexible exchange rate
- n. Government Accountability Office (GAO)
- o. member bank
- p. ROCA score
- q. Strength of Support Assessment (SOSA)
- r. System to Estimate Examinations Ratings (SEER)
- s. Taylor rule
- t. Truth in Lending Act (TILA)
- u. U.S. Treasury Exchange Stabilization Fund (ESF)

Review Concepts

10. Name the four organizational components of the Federal Reserve System.

11. What four functions does the Federal Reserve perform?

12. Describe the structure and purpose of the FOMC.

13. How does Keynesian economics relate to fiscal policy?

14. Explain the role of an adverse feedback loop in the recent credit crisis.

15. How does the balance of payments impact a flexible exchange rate?

16. Why is it significant which government agency issued a bank's charter?

17. How does the SEER report help regulators?





18. Why is the government interested in helping private investors aid banks that are struggling?

19. Describe the membership and objectives of the IMF.

20. Why did the U.S. transition from a fixed exchange rate to a flexible exchange rate?

Apply What You Learned

21. What is the advantage of distancing the Federal Reserve System from politics?

22. Why is inflation a constant concern of the Federal Reserve Board?

23. Describe the differences between monetary and fiscal policy.

24. As of August 2008, the Australian dollar was worth \$0.8815 U.S. dollars and the Indian rupee was worth \$42.9057. How many Australian dollars and Indian rupees would a U.S. dollar have bought at that time?

25. Name four consumer protection laws related to lending.

26. How would it help the banking industry if the amount a private equity firm could invest in a bank was increased beyond 10 percent?

Make Academic Connections

27. **POLITICAL SCIENCE** If inflation is such a concern, why not just stabilize the economy by imposing wage and price controls? Wages and prices have occasionally been frozen before in emergency situations. Should wage and price controls be permanently established? Write a paragraph that summarizes your opinion.

28. **SOCIAL STUDIES** Choose one of the laws discussed in lesson 3.3, Consumer Protection. Prepare a detailed report on its history, its provisions, and its effect on the lending industry. Write a three-page report on what you learn.

29. **CURRENT EVENTS** Consumer protection also applies to student loans. In September 2008, the *New York Times* reported that seven student loan companies were required to develop a \$1.4 million dollar fund to help educate students and their parents on student loans. The companies were cited for misleading advertising practices, including sending students marketing materials that looked like they came from the federal government. Research any new cases where the government intervened to protect consumers' rights. Prepare a one-page report to summarize your findings.

