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USA banking system

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1 INTODUCTION

With nearly 90,000 branches and 371,000 automated teller machines (ATMs), US banking system is the largest in the world. As of September 30th 2004, US banks had US$9.88 turn in assets and US$5.98 turn in total loans. US banking is more diverse than in most Western countries. Despite ongoing consolidation, vigorous competition exists within the vast banking community, which includes financial holding companies that operate nationwide, dominant regional banks and smaller independents.[1]

The USA banking system, as with many services, differs from state to state. Each state has its own commercial and consumer guidelines. It is important for property buyers to understand the local system and have a cheque account in order to establish a credit rating and pay utility bills. In recent years, mortgage companies have sprung up throughout the USA and, as they do not have the overheads of the banking institutions, they can sometimes offer more favorable terms, having taken a large share of the market from the more traditional banks.

According to Sandrine Rastello's report from White House, Washington, in July 2010, The U.S. financial system remains fragile and banks subjected to additional economic stress might need as much as $76 billion in capital, according to the results of International Monetary Fund stress tests. The findings, released in July as part of a broader IMF report on the U.S. financial system, suggested that while the nation’s banking system is stable, it remains vulnerable. Home prices, commercial real estate loans and economic growth have the potential to cause shocks that could expose banks to more losses. Under one scenario, small and regional banks as well as subsidiaries of foreign banks would need $40.5 billion in additional capital to meet a benchmark capital ratio of 6 percent Tier 1 common equity from 2010 to 2014. Under the adverse scenario, those needs rise to $76.3 billion, according to the report.

[1] www.bankingsystems.pdf

2 EARLY HISTORY OF U.S. BANKING SYSTEM

In 1780, in order to help fund the American Revolutionary War, Congress founded the Bank of Pennsylvania. Only a year later, the same Congress established the Bank of North America.

Previous attempts to finance the war were not successful, and Robert Morris, the first Superintendent of Finance had to find another way to support the war efforts. He suggested that the Bank of North America should be a commercial bank, but also a sole fiscal and monetary agent of the new government. He became "the father of the system of credit and paper circulation in the United States"[2] The idea was not original, it was the same way that the Bank of England was organized. Later, after the war, the state chartered a few more banks, such as the Bank of New York in 1784 and the Bank of Massachusetts.

In 1791. Congress chartered the First Bank of the United States, succeeding the Bank of North America. Due to a simple administrative failure, Congress had to charter another one, the Second Bank of the United States in 1816. Between 1784 and 1830, many of the smaller banks were chartered, due to own franchise laws. These banks were merely the intermediaries between the entrepreneurs and the investitors, and this can be considered to be the beginning of the American dream: wealth people had the funds, entrepreneurs had the ideas, these banks were the missing link, they were able to give certain guarantees for both of them. These banks encouraged the financial evolution in the country, in spite somewhat discriminatory practice with insider landing.

2.1 Free banking era

A period between 1837 and 1863 is called the Free banking era. The Second Bank of United States was shuttered, so there were no central banks, and many states adopted free banking laws.[3] These banks were able to issue bank notes against specie, gold or silver, with states regulating interest rates, loans, deposits, capital ratio etc. According to the Michigan Act, any bank who would fulfill certain requirements would be automatically chartered, with

[2] Goddard, Thomas H. (1831). History of Banking Institutions of Europe and the United States. Carvill. pp. 48–50.

[3] "A lesson from the free banking era". Federal Reserve Bank of St. Louis - Regional Economist. 1996. http://findarticles.com/p/articles/mi_qa3678/is_199604/ai_n8755671/.

or without special consent of state laws. The 1837 Michigan Act was adopted as the first of the nation's free banking laws. One could describe a free banking system as one without any form of government restriction on banking activities or prohibitions against fraud. Basicly, The Michigan Act granted a banking charter to anyone, would it be a person or group that satisfied established criteria.

2.2 Dual banking system

If you consider 1840s and 1850s to be the Free banking era, 1860s were the period of Dual banking system. It was 1863 when Congress passed the National Bank Act. The idea was to submit as many of the state banks to Federal supervision, and in 1865, Congress began taxing state bank notes a standard rate of 10%. The result was almost immediate, most of the state banks become national ones. But, this taxing gave a unique idea to the state banks, they invented a "demand deposit accounts", further known as checking accounts. The result of these actions is now known as "the dual banking system". Banks and their owners had a choice, national or state charter, but there were no limits or restrictions, a bank could convert its charter at any time, back and forward.

This was the end of the 19th century. Commercial banks were the necessity, since entrepreneurs needed someone to rely on, but also, wealthy people needed some sort of guarantee for their investments. Inside lending, factories, numerous project relied on commercial banks, and in the end of 1870s, New England was one of the most heavily banked areas in the world.

3 FEDERAL RESERVE SYSTEM

In 1913, the Federal Reserve act finished what the National Bank Act had initiated. It brought all the banks in the US under the authority of the Federal Reserve, which became a quasi- governmental entity). Twelve regional Federal Reserve Banks were founded, all of them supervised by the Federal Reserve Board.

There were a few attempts to reform this system, a Glass-Steagall Act in 1932, the Banking Act in 1933 and the Banking Act in 1935. Nevertheless, this system has remained more or less unchanged through to the present day. The Glass-Steagall Act was repealed after

67 years, and the Banking Act merely reinforced the powers of federal authorities. This act also created the Federal Deposit Insurance Corporation.

3.1 History of Federal reserve system (central banking)

The Massachusetts Bay Colony issued the first paper printed money on the continent. Soon, other colonies followed this idea, because there was a scarcity of coins, and the growing trade needed some sort of value. It was the simplest way to pay for expenses, but also, these bills soon became the primary means of exchange, inside the colonies and between them.

During the Revolutionary war, in 1775, the Continental Congress made the first attempt at a national currency, issuing the paper currency later known as "Continentals". Unfortunately, it was not supported by gold nor silver, and had almost no value. From 1791 until 1811, the First Bank of US was granted a charter to operate as the United States central bank. The first two banks did not last for long, the first one needed under the President Madison, and the second one under the President Jackson, they both refused to renew their charters, and no one could give a precise explanation why. The third one, The Federal reserve bank, still exists for 97 years, since 1913. Table below shows a brief history of US banking system:

1791-1811	First Bank of the United States
1811-1816	No central bank
1816-1836	Second Bank of the United States
1837-1862	Free Bank Era
1846-1921	Independent Treasury System
1863-1913	National Banks
-1913	Federal Reserve System

The creation of First Central Bank took place in 1791, under the President George Washington, in spite of strong opposition from Thomas Jefferson and James Madison. However, when Madison became a president, he refused to renew the charter and the bank was closed.

Five years later, President Madison established the Second Bank of the United States. Confrontation between the President Jackson and Nicholas Biddle, President of the Second

Bank of United States, forced the country into recession. The bank accused Jackson's policies, since the president pulled the government's funds out of the bank, and Jackson blamed it on Biddle. However, there was one good thing about this quarrel, Jackson is the only President in the history of the United States to completely pay off the national debt. In spite of the recession, Jackson persuaded the Congress not to renew the bank's charter in 1836.

The Third Central Bank was founded in 1913. It was obvious that the country needs banking and currency reform. Between 1875 and 1907, there was a series of financial panics in the economy of the United States. Existing national banking system had two soft spots: an inelastic currency and a lack of liquidity[4]. When in 1908, Congress enacted the Aldrich-Vreeland Act, it established the National Monetary Commission in order to study banking and currency reform.[5] These recommendations later became the basis of the Federal Reserve Act, passed in 1913. The head of this commission was Nelson Aldrich, who was both senator and a financial expert. He formed two separate commissions. One of them, headed by Aldrich, had the important task, to study the European central banking systems and give the basic boundaries for the American form of it. The other commission was established in order to study the weaknesses of the American monetary system. Aldrich was strongly against the idea of central banking, he was determined to declare any central banking system a bad one, but, after he went to Germany, ha had to change his mind. It was obvious, a centralized bank was better than the government-issued bond system that he had previously supported.

In early November 1910, Aldrich met with five well known members of the New York banking community to devise a central banking bill. Paul Warburg, an attendee of the meeting and long time advocate of central banking in the U.S., later wrote that Aldrich was "bewildered at all that he had absorbed abroad and he was faced with the difficult task of writing a highly technical bill while being harassed by the daily grind of his parliamentary duties."[6] It took them ten days to agree upon a document, later known as the "Aldrich plan". It included a central bank with a headquarters in Washington DC, fifteen branches all over the USA and currency based on gold. Although a central banking system with no political

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4 Flaherty, Edward (June 16, 1997, updated August 24, 2001). "A Brief History of Central Banking in the United States". Netherlands: University of Groningen. http://odur.let.rug.nl/~usa/E/usbank/bank00.htm.

5 Whithouse, Michael (May 1989). "Paul Warburg's Crusade to Establish a Central Bank in the United States". The Federal Reserve Bank of Minneapolis. http://www.minneapolisfed.org/pubs/region/89-05/reg895d.cfm.

6 "Paul Warburg's Crusade to Establish a Central Bank in the United States". The Federal Reserve Bank of Minneapolis. http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3815.

involvement would be the best option, it seemed that a plan with no public control would not be politically feasible. The compromise between these two was a representation of the public sector on the Board of Directors.

Aldrich's bill was not welcomed. His personal and family connections with the wealthiest families in USA, such as Morgans and Rockefellers, caused a lot of debate. Also, western countries refused to accept this plan, since it was "created in the eastern establishment".[7]

Republicans favored the Aldrich Plan, Democrats, on the other hand, believed that a reserve system owned and operated by the government is a much better solution. They believed that public ownership of the central bank would end Wall Street's control of the American currency supply. Conservative Democrats fought for a privately owned, yet decentralized, reserve system, which would still be free of Wall Street's control.[8]

Unfortunately for the Aldrich Plan, in 1912, Democrats won the White House and Congress. The new President, Woodrow Wilson, believed that the Aldrich plan only needs a few modifications. Senator Robert Owen in May 1913 proposed the Federal Reserve Act, based on the Aldrich Plan. In the Federal Reserve Act, the Board of Directors became The Federal Open Market Committee, controlled by the government. Most of the Democrats voted in favor, most of the Republican voted against it, and the bill passed the Congress in the end of 1913. Key laws affecting the Federal Reserve have been:[9]

- Federal Reserve Act
- Glass-Steagall Act
- Banking Act of 1935
- Employment Act of 1946
- Federal Reserve-Treasury Department Accord of 1951
- Bank Holding Company Act of 1956 and the amendments of 1970
- Federal Reserve Reform Act of 1977
- International Banking Act of 1978

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7 "America's Unknown Enemy: Beyond Conspiracy". American Institute of Economic Research. http://www.cooperativeindividualism.org/aier_on_conspiracy_04.html

8 "America's Unknown Enemy: Beyond Conspiracy". American Institute of Economic Research. http://www.cooperativeindividualism.org/aier_on_conspiracy_04.html.

9 http://en.wikipedia.org/wiki/Federal_Reserve_System#CITEREFBoG2005

- Full Employment and Balanced Growth Act (1978)
- Depository Institutions Deregulation and Monetary Control Act (1980)
- Financial Institutions Reform, Recovery and Enforcement Act of 1989
- Federal Deposit Insurance Corporation Improvement Act of 1991
- Gramm-Leach-Bliley Act (1999)
- Emergency Economic Stabilization Act (2008).

3.2 *Purpose of Federal reserve system*

The Federal Reserve System was mainly created in order to calm down frequent banking panics. Other purposes are stated in the Federal Reserve Act, such as "to furnish an elastic currency, to afford means of re discounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes".[10] There were several financial crises between 1907 and 1913, but, since 1913 Federal Reserves system is responsible for ensuring the stability of the financial system. Current functions of the Federal Reserve System include:[11]

1. To address the problem of banking panics
2. To serve as the central bank for the United States
3. To strike a balance between private interests of banks and the centralized responsibility of government

- To supervise and regulate banking institutions
- To protect the credit rights of consumers

4. To manage the nation's money supply through monetary policy to achieve the sometimes-conflicting goals of

- maximum employment
- stable prices, including prevention of either inflation or deflation
- moderate long-term interest rates

5. To maintain the stability of the financial system and contain systemic risk in financial markets

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[10] "The Federal reserve act" by Clarence Walker Barron (1914). p. 151. "An Act To provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes."

[11] Flamme, Karen. "1995 Annual Report: A Brief History of Our Nation's Paper Money". Federal Reserve Bank of San Francisco. http://www.frbsf.org/publications/federalreserve/annual/1995/history.html. Retrieved October 7th, 2010.

6. To provide financial services to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation's payments system

- To facilitate the exchange of payments among regions
- To respond to local liquidity needs

7. To strengthen U.S. standing in the world economy

Banking institutions in the United States are only required to hold a fraction of their depositors' money in reserve, and this practice is called fractional-reserve banking. This allows banks to invest majority of the funds, but it is a problem if a large amount is withdrawn from the bank. In this case, a bank needs help from the outside in order to continue operating, and this is why the Federal reserve was established for. It is a lender of last resort if a bank run does occur. However, in 1929, Federal Reserves refused to lend money to small banks. It caused a domino effect, and it took many years for the American economy to recover from Depression.

Every year, around Christmas, a new currency is being printed, so that people can withdraw their money from the banks. It is removed from the circulation in January, when there is no more need for so much cash. The only way to prevent bank runs is to have a strong base of money supply, whenever the cash is needed. The term "elastic currency" means the ability to expand the money supply, and the ability to contract it. According to the Federal Reserve Act, elastic currency is:[12] "Currency that can, by the actions of the central monetary authority, expand or contract in amount warranted by economic conditions." Monetary policy of the Federal Reserve System is based on the theory that it is best overall to expand or contract the money supply as economic conditions change.

Some banks refused to clear checks from other banks during the 1930s., so a check-clearing system had to be created inside the Federal Reserve system. It is described in The Federal Reserve System—Purposes and Functions as follows:[13]

"By creating the Federal Reserve System, Congress intended to eliminate the severe financial crises that had periodically swept the nation, especially the sort of financial panic

[12] http://www.dallasfed.org/educate/everyday/ev4.html

[13] Andrews, Edmund L.; Michael J. de la Merced and Mary Williams Walsh (2008-09-16). "Fed's $85 Billion Loan

that occurred in 1907. During that episode, payments were disrupted throughout the country because many banks and clearinghouses refused to clear checks drawn on certain other banks, a practice that contributed to the failure of otherwise solvent banks. To address these problems, Congress gave the Federal Reserve System the authority to establish a nationwide check-clearing system. The System, then, was to provide not only an elastic currency—that is, a currency that would expand or shrink in amount as economic conditions warranted—but also an efficient and equitable check-collection system".

According to the Federal Reserve Bank of Minneapolis, "the Federal Reserve has the authority and financial resources to act as 'lender of last resort' by extending credit to depository institutions or to other entities in unusual circumstances involving a national or regional emergency, where failure to obtain credit would have a severe adverse impact on the economy."[14] The Federal Reserve System's role as lender of last resort has been criticized because it shifts the risk and responsibility away from lenders and borrowers and places it on others in the form of inflation.

3.3 Structure of Federal reserve system

Organization of the Federal Reserve System

The Federal Reserve System is completely independent, can make decisions without anyone's permission. It does not require public funding, and it's authority and purpose relies on the Federal Reserve Act from 1913. Key aspects of the system are regional Federal Reserve Banks and Open Market Committee.

Board of Governors

The Board of Governors is the main governing body of the FRS, and it has seven members. It is the headquarters for the 12 District Reserve Banks, but also, it helps implementing national monetary policy. One of the responsibilities of this Board is supervision and regulation of the United States banking system in general. Members of the board, called the Governors, are appointed by the current President of the United States and confirmed by the Senate. Their terms last for 14 years, longer than any other term in politics. This Board makes annual reports to the Speaker of the US House of Representatives. President also appoints the Chairman and the Vice Chairman, and it has to be someone who is already a member of the Board. Their term lasts for four years, and can be prolonged for as

[14] Lender of last resort, Federal Reserve Bank of Minneapolis, http://www.minneapolisfed.org/glossary.cfm?js=0#l

long as they are the members of the Board. Members of the Board have no obligations, and are free to leave at any time, even without any explanation. In those cases, they usually leave "for personal reasons". The current members of the Board of Governors are:[15]

Commissioner	Entered office[63]	Term expires
Ben Bernanke (Chairman)	February 1, 2006	January 31, 2020 January 31, 2014 (as Chairman)
Janet Yellen (Vice Chairman)	October 4, 2010	January 31, 2024 October 4, 2014 (as Vice Chairman)
Kevin Warsh	February 24, 2006	January 31, 2018
Elizabeth Duke	August 5, 2008	January 31, 2012
Daniel Tarullo	January 28, 2009	January 31, 2022
Sarah Bloom Raskin	October 4, 2010	January 31, 2016
Vacant	——	

Federal Open Market Committee

The Federal Open Market Committee (FOMC) consists of the Board of Governors plus five representatives from the regional Federal Reserve Banks. The FOMC oversees open market operations, which affect the amount of Federal Reserve balances available to depository institutions. Subsequently, it influences monetary and credit conditions. The representative from the Federal Reserve Bank of New York, is a permanent member, while the rest of the banks rotate at two- and three-year intervals. Traditionally, the Chairman of the Board of Governors is also the Chairman of the FOMC, and the president of the Federal Reserve Bank of New York as its vice chairman. FOMC meets eight times each year, and when voting no more than two FOMC members can dissent.

Federal Reserve Districts

There are 12 Federal Reserve Banks which are located in: Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St Louis, Minneapolis, Kansas City, Dallas, and San Francisco. Districts were set when the Federal Reserve Act passed, in 1913.

[15] http://www.federalreserve.gov/aboutthefed/bios/board/default.htm

Regional banks are responsible for member banks in its district, have their own Presidents, nominated by the Bank's board of directors, and confirmed by the Board of Governors. They serve a five year terms and can be reappointed.

"Each regional Bank's board consists of nine members. Members are broken down into three classes: class A, class B, and class C. There are three board members in each class. Class A members are chosen by the regional Bank's shareholders, and are intended to represent member banks' interests. Member banks are divided into large, medium, and small. Each size bank elects one of the three class A board members. Class B board members are also nominated by the region's member banks, but class B board members are supposed to represent the interests of the public. Lastly, class C board members are nominated by the Board of Governors, and are also intended to represent the interests of the public."[16] Term "member bank" refers to private bank that owns stock in the regional Federal Reserve Bank.

Legal status of regional Federal Reserve Banks

The Federal Reserve Banks have an intermediate legal status, with some features of private corporations and some features of public federal agencies. The charter of each Federal Reserve Bank is established by law and cannot be altered by the member banks. Federal Reserve Bank stock cannot be sold or traded, and member banks do not control the Federal Reserve Bank as a result of owning this stock. They do, however, elect six of the nine members of the Federal Reserve Banks' boards of directors.

In Lewis v. United States, the United States Court of Appeals for the Ninth Circuit stated that: "The Reserve Banks are not federal instrumentalities for purposes of the FTCA [the Federal Tort Claims Act], but are independent, privately owned and locally controlled corporations."[17] The opinion went on to say, however, that: "The Reserve Banks have properly been held to be federal instrumentalities for some purposes."

3.4 Central Bank

The Fed serves as a banker's bank and as the government's bank. As the banker's bank, it helps to assure the safety and efficiency of the payments system. As the government's bank, or fiscal agent, the Fed processes a variety of financial transactions involving trillions of dollars. The system is rather simple, just as you or I keep our accounts in our banks, US

[16] http://www.law.cornell.edu/uscode/html/uscode12/usc_sup_01_12_10_3_20_VII.html
[17] http://bulk.resource.org/courts.gov/c/F2/680/680.F2d.1239.80-5905.html

treasury Department keeps a checking account in Fed, for handling incoming federal tax deposits and government payments.

"Federal funds" are the reserve balances that private banks keep at their local Federal Reserve Bank.[18] The reason for keeping funds at a Federal Reserve Bank is to have a mechanism for private banks to lend funds among each other. Monetary policy consists of influencing on the rate the private banks charge each other for the lending of these funds.

Government regulation and supervision

Federal Banking Agency Audit Act enacted in 1978 as Public Law 95-320 and Section 31 USC 714 of U.S. Code establish that the Federal Reserve may be audited by the Government Accountability Office (GAO).[19] Audits of the Reserve Board and Federal Reserve banks may not include:[20]

1. transactions for or with a foreign central bank or government, or non private international financing organization;
2. deliberations, decisions, or actions on monetary policy matters;
3. transactions made under the direction of the Federal Open Market Committee; or
4. a part of a discussion or communication among or between members of the Board of Governors and officers and employees of the Federal Reserve System related to items (1), (2), or (3).

[18] http://www.newyorkfed.org/aboutthefed/fedpoint/fed15.html
[19] http://www.federalreserve.gov/generalinfo/faq/faqfrs.htm
[20] http://www.federalreserve.gov/generalinfo/faq/faqfrs.htm

4 CONCLUSION

In the United States of America three kinds of institutions must be distinguished : the national banks, the state banks and private institutions which have sprung up without the authorization of any special or general statute. In 1900 the number of the national banks was 3732, of state banks 4369, and of private banks more than 6000.

The national banks occupy a central and dominant position in this system. These banks are supervised and regulated by the federal government, and are the most convenient correspondents for the state and private banks. They have the monopoly of the right of note issue[21].

Every institution which is organized under the authority of the National Banking Act is obliged to invest a portion of its capital in United States registered bonds, to the par value of which it is permitted to issue notes, provided their market value is not below that point. These bonds must be placed on deposit with the Comptroller of the Currency at Washington, and in addition an amount of cash equal to five per cent of the notes circulated by the bank[22].

For banks located in a number of above mentioned cities, designated as reserve cities, the minimum cash reserve is fixed at twenty-five per cent of the aggregate amount of the notes and deposits. For all others the limit is fifteen per cent of this aggregate. It is impossible to summarize all the regulations considering US banking system in one essay, but I hope this essay to clarify some of the basic regulations and the general way the system works.

[21] http://chestofbooks.com/finance/banking/Money-And-Banking/2-The-Banking-System-Of-The-United-States.html

[22] http://chestofbooks.com/finance/banking/Money-And-Banking/2-The-Banking-System-Of-The-United-States.html

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