FEDERAL RESERVE BANK *of* NEW YORK

The Federal Reserve's Role in the Financial System

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Banks and the financial system

Banks create liquidity by issuing short-term liabilities while holding long-term assets.

That activity necessarily makes them fragile in the sense of potentially being subject to runs.

The financial system and stability

The Federal Reserve serves the financial system as

- issuer of monetary liabilities,
- lender of last resort,
- supervisor of banking organizations, and
- provider of payment services to banks.

All these activities are intended to improve the resiliency of the financial system as well as to improve its efficiency.

Discussion question: should all these responsibilities be housed in one institution?

Financial instability

Financial systems dependent on banks are at risk of unstable behavior, such as a financial crisis, which we would define as widespread bank runs, or runs spreading to other types of financial intermediaries.

Central bank history

The Federal Reserve was created, in part, as a reaction to the recurring panics of the National Bank era (1863-1914) in 1857, 1873, 1893, and1907.

The Federal Reserve Act directed the Fed "to furnish an elastic currency, to afford means of rediscounting commercial paper, [and] to establish a more effective supervision of banking in the United States."

The Banking Act of 1935 amended the Federal Reserve Act "to provide for the sound, effective, and uninterrupted operation of the banking system" and afforded the System greater regulatory and supervisory authority over banking organizations.

The Federal Reserve's tools for financial stability

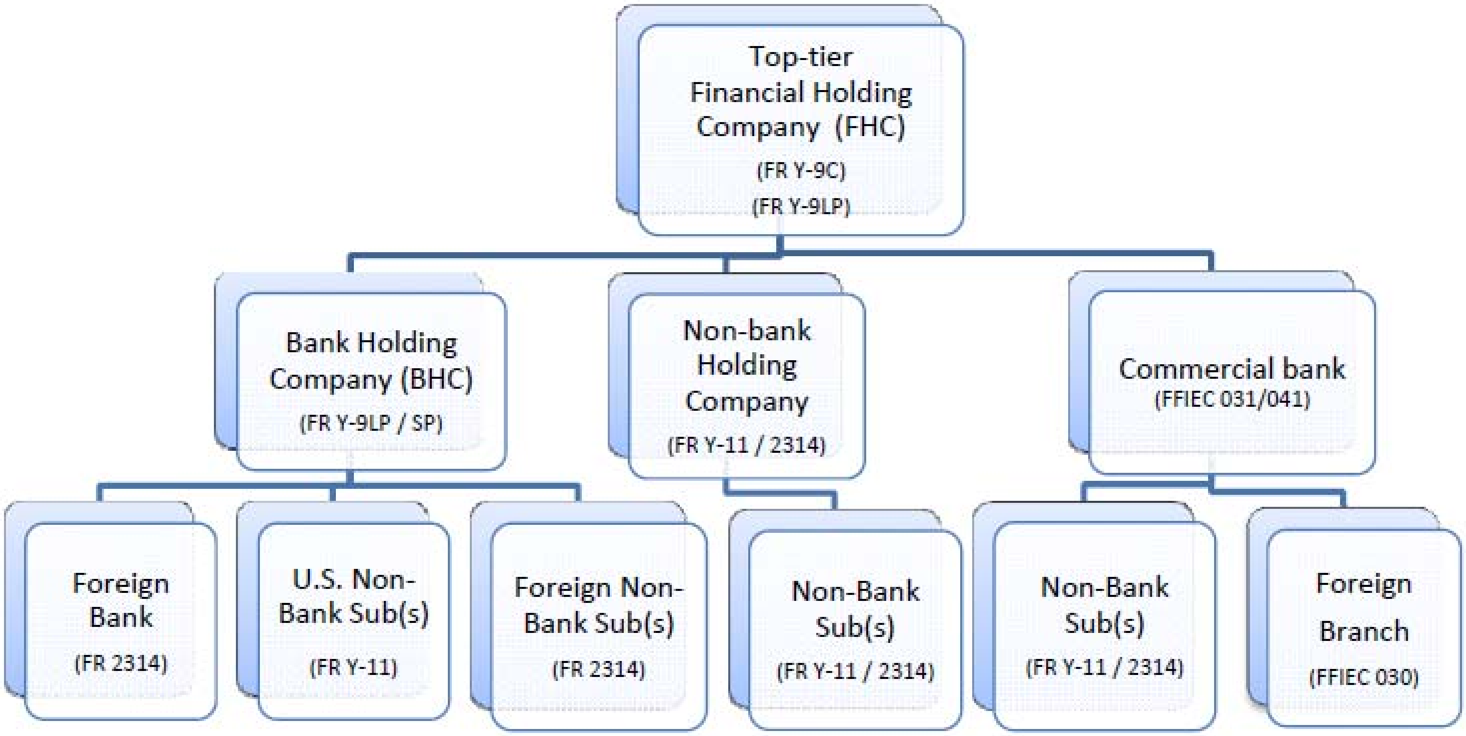
Banking Supervision

Historically, the Fed supervised state "member" banks, but after passage of the Bank Holding Company Act, the Fed became the main supervisor of the consolidated banking firms.

This task has become more complicated over time as the financial system has grown

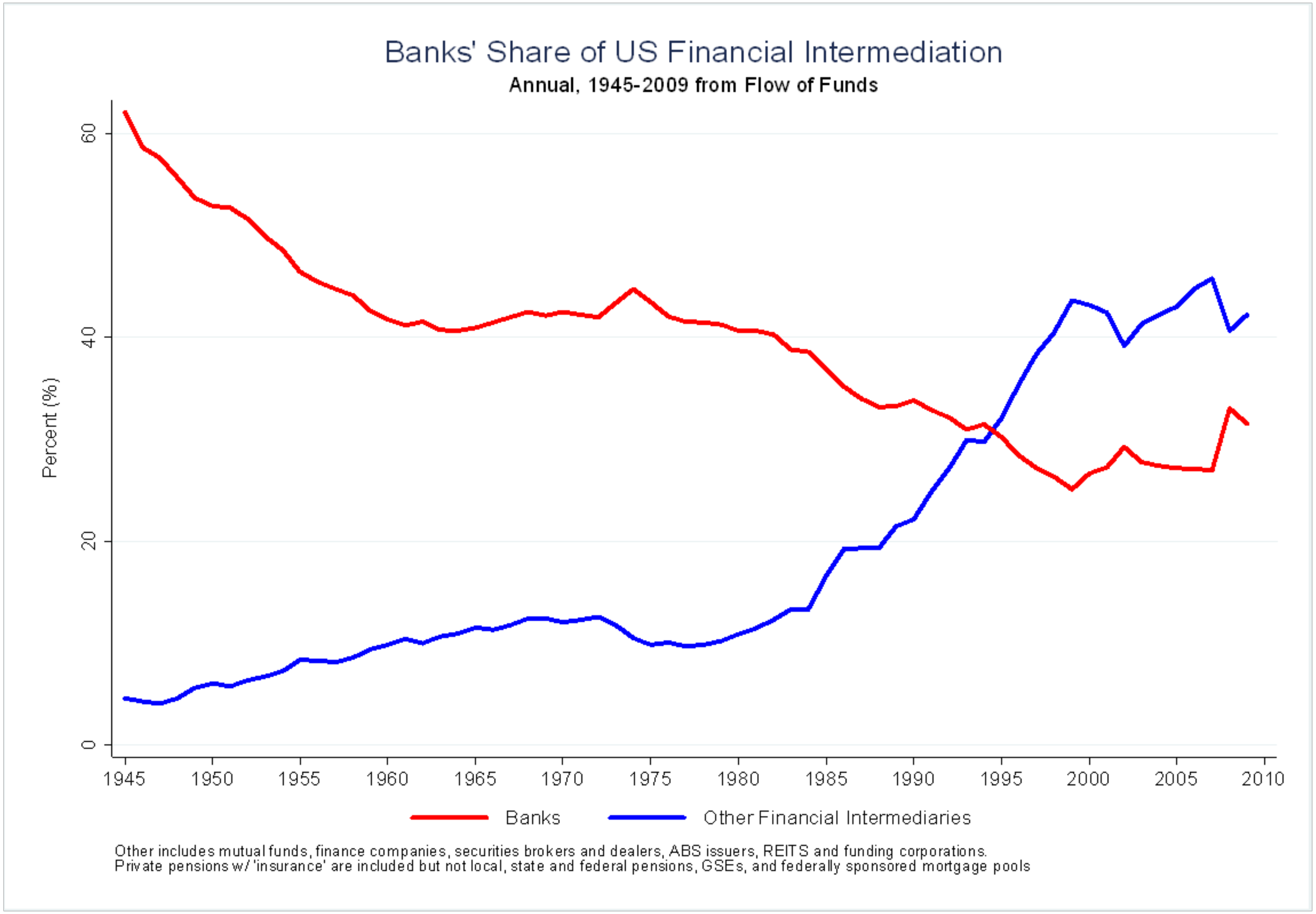
- As more wealth accumulation has occurred, and
- As more resources have been devoted to finance as a share of the economy.

The Federal Reserve is the supervisor of consolidated Financial Holding Companies, and State Member banks



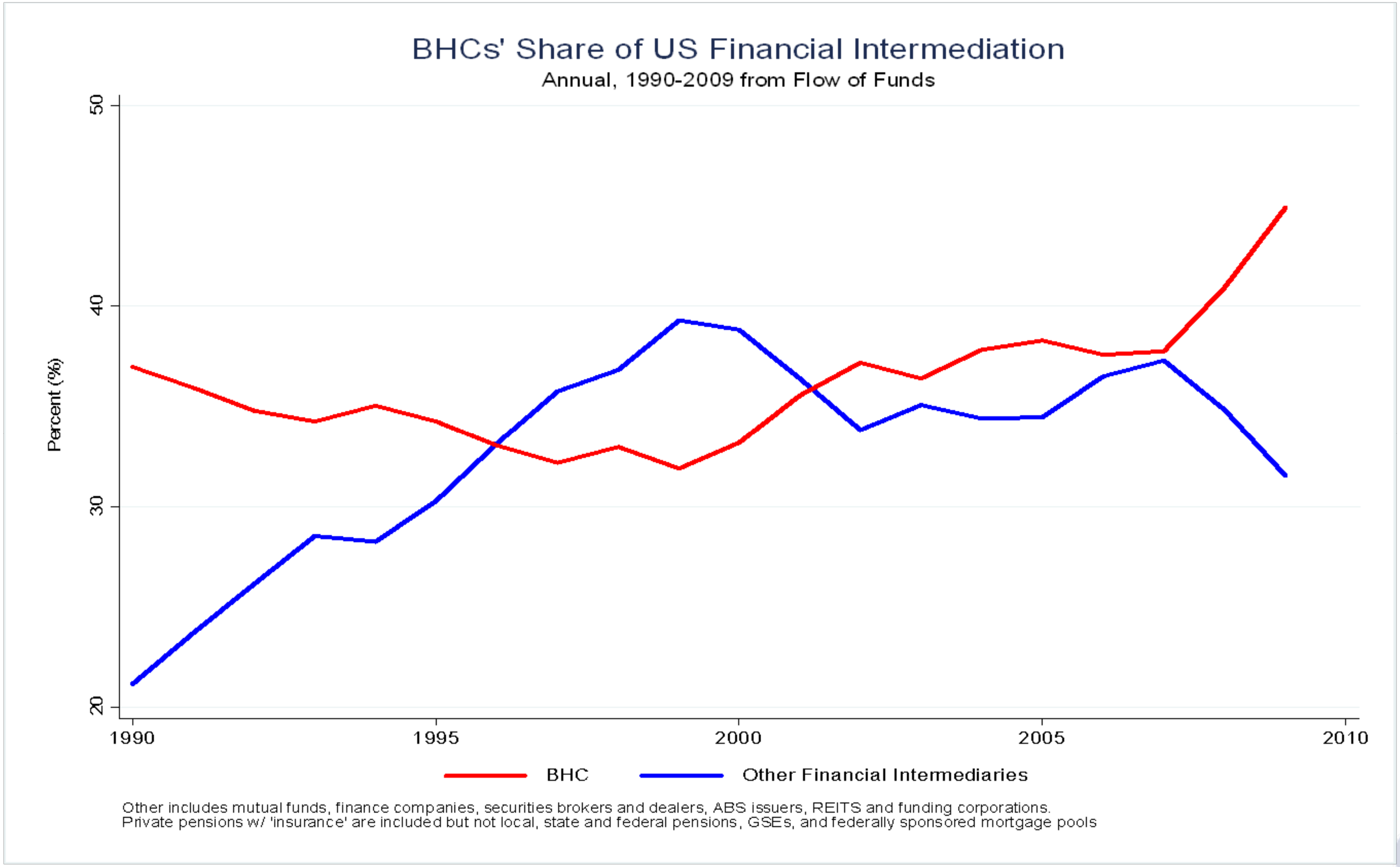
The Federal Reserve's tools for financial stability

Banks' share of financial intermediation in U.S. has fallen over a long period



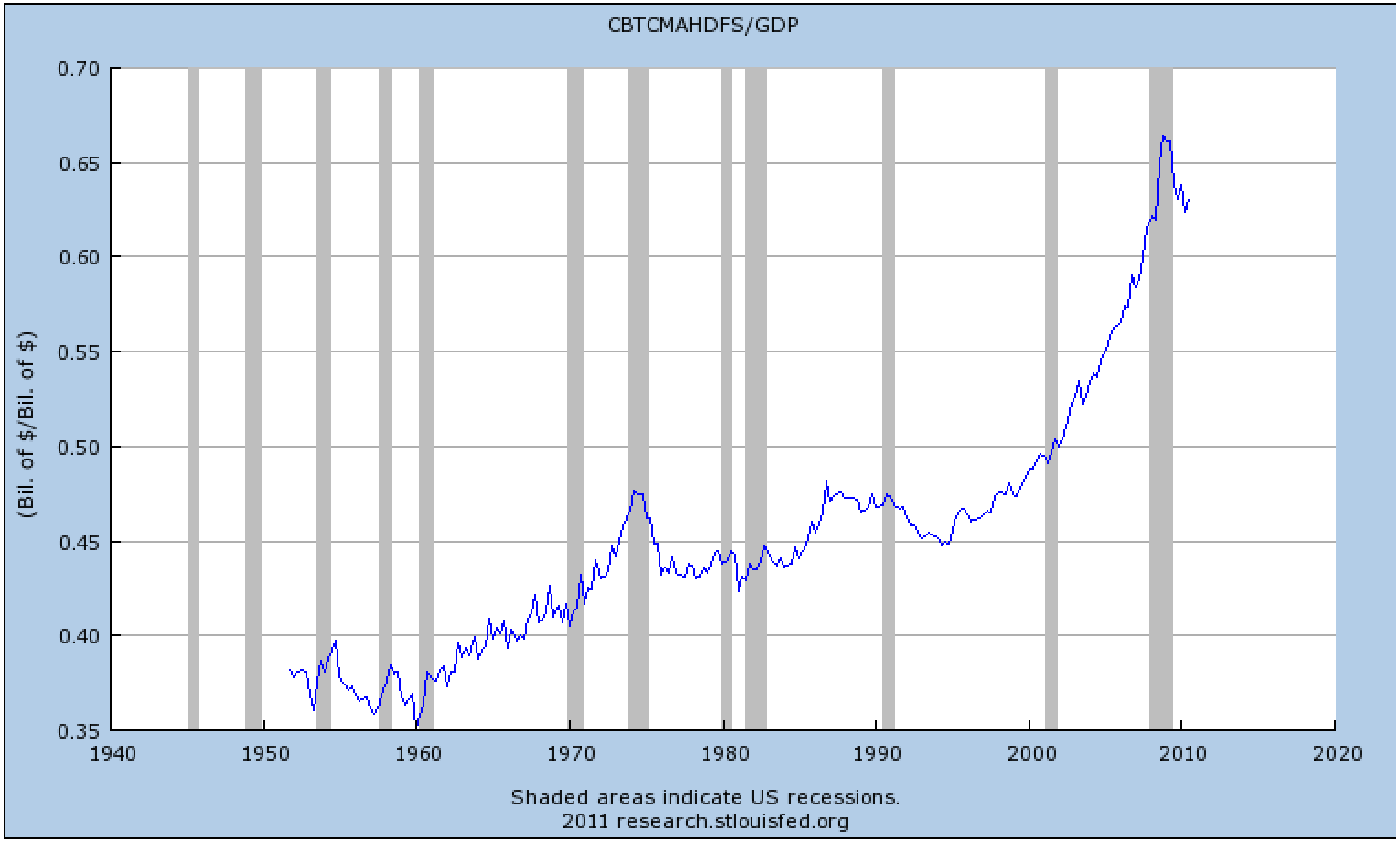
The Federal Reserve's tools for financial stability

Bank Holding Companies' share of financial intermediation in U.S. has been stable.



Commercial bank credit as share of GDP

Nonetheless, although banks' relative share of financial intermediation has shrunk, banking activity has grown as a part of the economy.



The Federal Reserve's tools for financial stability

Financial stability monitoring.

In conducting bank supervision and in interacting with market participants through its open market operations, the Fed gathers a great deal of information on current conditions in markets and institutions.

The Fed, together with other financial regulators, has new responsibilities under Dodd-Frank, which will be discussed in a separate session.

Lender of last resort

" to afford means of rediscounting commercial paper…"

Rediscounting is simply secured lending. That is, lending against the collateral of some security.

This can be a powerful tool, as it may prevent banks or others from selling securities quickly in anticipation of a crisis, or if private funding is unavailable for some reason. Preventing those "fire sales" may forestall the crisis.

The Fed has different authorities to engage in secured lending. The discount window provides secured loans to banks.

During the recent financial crisis, new facilities for secured lending to institutions other than banks were introduced.

The Federal Reserve's tools for financial stability

During the crisis, the Fed developed many different forms of "discount window" actions, all of which reflecting the extent to which banking has evolved over the decades.

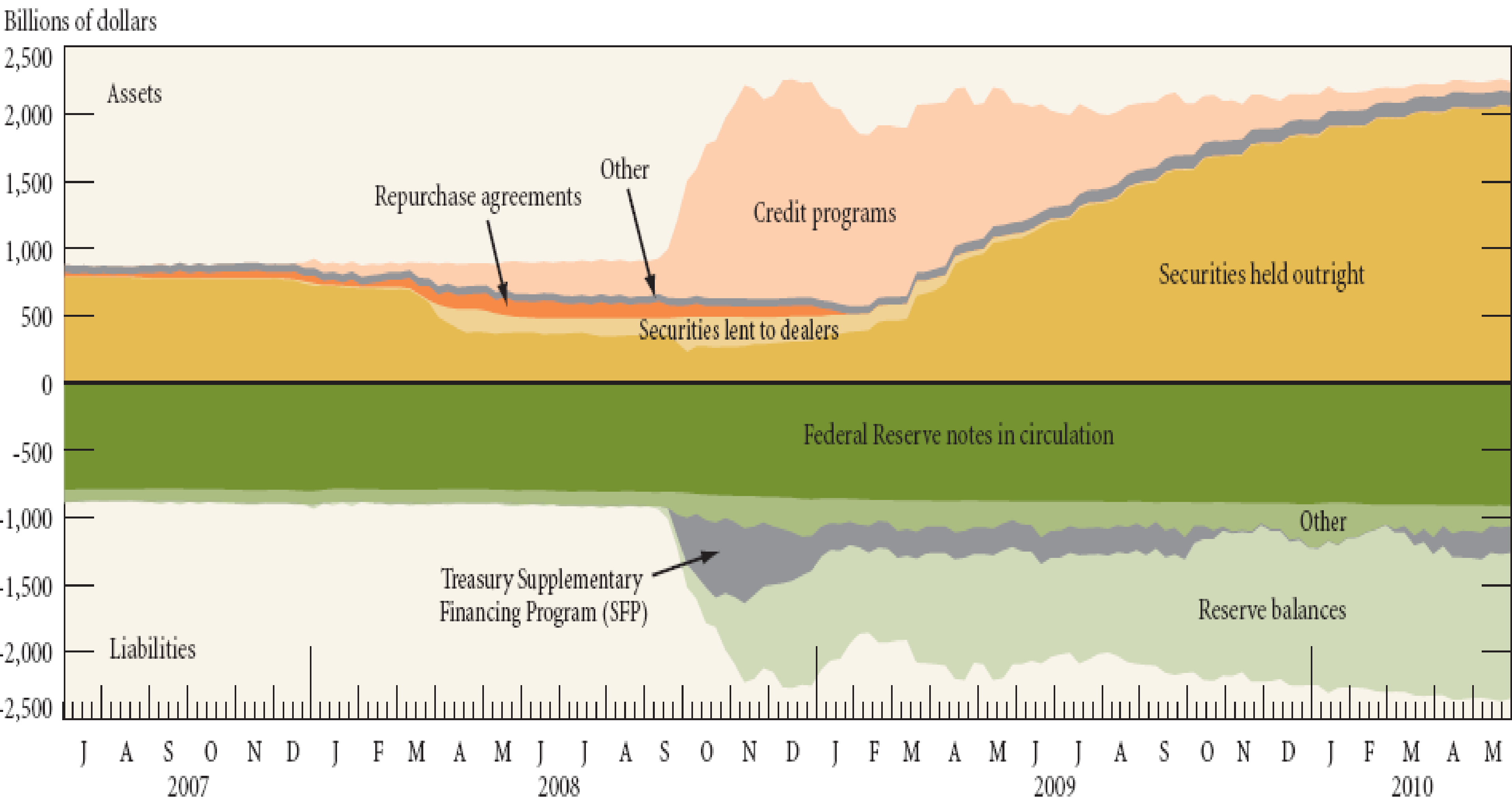
TAF, TSLF, PDCF, AMLF, MMIFF, CPFF, TALF

Many of these facilities

- lent funds to nonbanks
- lent against a wider variety of collateral
- lent for longer terms.

The size of the Fed's lending in the crisis

Assets and Liabilities of the Federal Reserve System



Source: Federal Reserve Statistical Release H.4.1, "Factors Affecting Reserve Balances."

The Federal Reserve's tools for financial stability

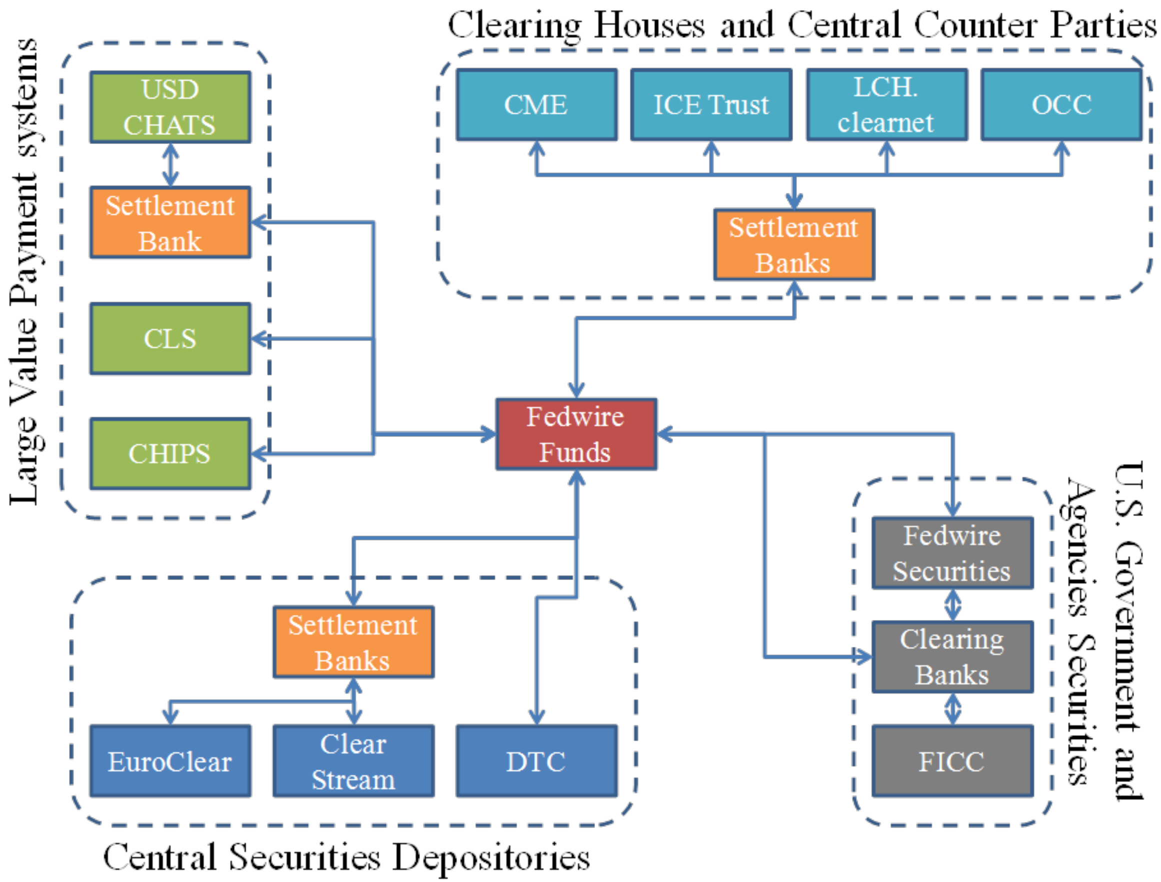
Payment provision and oversight.

The Fed provides accessible, safe, and efficient payment services in cash distribution, check clearing, ACH processing, Treasury and Agency debt depository and settlement services, and wire transfers.

These services are vital to the uninterrupted operation of the banking system.

In addition, the Fed provides oversight to private payments and settlement systems to limit both the operational risks of the systems as well as their risks of failing to settle for some reason.

Fedwire sits at the center of the daily operation of the financial system



The Federal Reserve's tools for financial stability

Interest rate policy. This tool is aimed at macrostability, and was reviewed in the monetary policy sections.

One interesting notable financial stability benefit from interest rate policy is the Fed's success, even as early as the 1920s, in removing of the significant seasonal variation in interest rates, which was largely coincident with the agricultural harvest cycle.

The Fed reduced seasonal swings in interest rates.

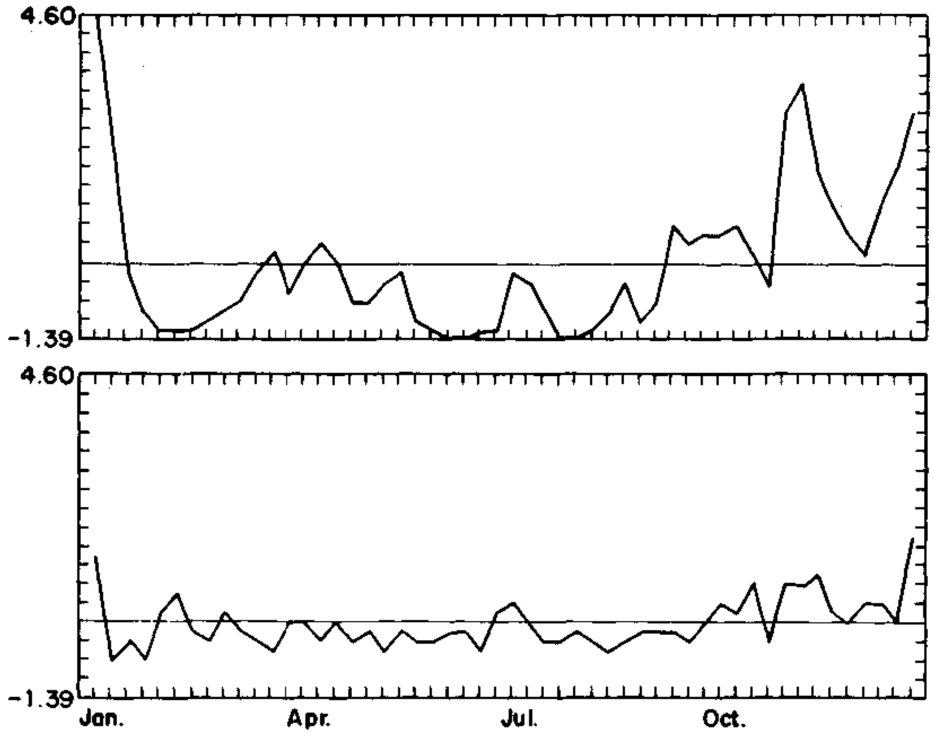


FIGURE 1. SEASONAL PATTERN IN NOMINAL INTEREST RATES, BEFORE (TOP) AND AFTER (BOTTOM) 1914

Interest rates on the “call loan” market did not show such big seasonal swings after the Fed began operations in 1914. This contributed to financial stability. “Financial Panics, the Seasonality of the Nominal Interest Rate,and the Founding of the Fed” Jeffrey A. Miron, *American Economic Review,* March 1986