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# FEDERAL RESERVE SYSTEM AND ITS ROLE IN THE EMERGENCE OF THE GLOBAL FINANCIAL CRISIS

***Abstract***

*This paper is devoted to the discussion of the principles of the US Federal Reserve System, the central bank of the largest economy in the world, and its contribution to the emergence of the financial crisis of 2008. At first, in Part II, the paper focuses on the general overview of the Federal Reserve System and its activities. The discussion, then, shifts to the structure of the Federal Reserve System and focuses on its key structural components that maintain the proper functioning of the U.S. central bank. The Part III will examine the history of past events preceding to the financial crisis, and analyze factors, including the Federal Reserve System's failures, which determined the growth of subprime mortgage bubble and its painful collapse. The Part IV (Conclusion) will summarize the regulatory failures of the Federal Reserve System, clarify the chronology of mistakes, and propose possible alternative approach.*

***Annotasiya***

*Bu məqalə dünyanın ən iri iqtisadiyyatının mərkəzi bankı olan ABŞ Federal Rezerv Sisteminin (FED) strukturu və fəaliyyət prinsiplərinin, habelə FED-in 2008-ci ilin qlobal maliyyə böhranının yaranmasındakı rolunun müzakirəsinə həsr edilmişdir. Məqalənin birinci hissəsində FED-in fəaliyyəti haqqında ümumi məlumat verildikdən sonra, həmin qurumun əsas funksiyalarını təmin edən struktur elementləri və onların iş prinsipi təhlil edilir. Üçüncü hissədə maliyyə böhranından əvvəlki tarixə nəzər salınmaqla, böhranın əsas yaranma səbəblərindən biri olmuş "subprime" ipoteka köpüyünün yaranmasını və partlamasını şərtləndirmiş faktorlar, o cümlədən FED-in maliyyə siyasətindəki səhvlər diqqətdən keçirilir. Məqalənin nəticə hissəsində FED-in maliyyə siyasətindəki nöqsanlar ümumiləşdirilməklə, alternativ anti-böhran tənzimləmə yanaşması təklif olunur.*

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# INTRODUCTION

In the early 20th century, the United States of America could set up the most efficient and powerful financial regulator ever existed. As the following events would prove, the creation of this regulatory institution, the so-called Federal Reserve System (hereinafter, the "Federal Reserve", the "System", or the "Fed") was a historic blessing for the United States. Since its establishment, the Fed played a key role in the phenomenal rise of the American might. Through its super-efficient domestic and international financial policies, the Fed reshaped the face of the global economy forever, and triggered the process of the US worldwide economic expansion. It also made the invaluable contribution to the success of political and military expansions of the US, by backing the country's imperialistic ambitions with strong monetary support.

The System was initially invented and later headed by the most talented and powerful economists, financiers, bankers and notorious businessmen of the US at the time.[1] Acting together these people could identify the essential needs of the country's economy and the ways to effectively address those needs. In a nutshell, the Federal Reserve directed all its efforts to the creation of the sustainable financial system, which would maximize employment in the country, keep the prices stable, and generate tremendous wealth and abundance. The Fed's approach and methods for the achievement of these goals were so successful that, eventually, they ended up with making America the wealthiest country in the world.

Today, another product of the System, the Federal Reserve note (or the US dollar), is the most well-known and recognized national currency in the world. Due to its stability and reliability, the US dollar became an irreplaceable instrument of the international trade. Most of the countries in the world, including very large economies, such as China, Russia, India, etc., hold considerable parts of their foreign exchange reserves in US dollars. As it is seen, the influence of the Fed to the world economy cannot be overestimated. That being said, the Fed is simply a financial institution directed by group people. These people, no matter how smart and sophisticated they are, sometimes make mistakes. In this paper, we will try to focus on particular regulatory failures of the Fed, which subsequently led or, if to be more correct, contributed to the emergence of the global financial crisis. Alongside, the paper will provide a substantial insight into the

[1] *The Federal Reserve was created 100 years ago. This is how it happened,* The Washington Post, https://www.washingtonpost.com/news/wonk/wp/2013/12/21/the-federal-reserve-was-created-100-years-ago-this-is-how-it-happened/ (last visited Nov. 25, 2015).

structure and functions of the Fed, its activities and key structural institutions that maintain the proper functioning of the U.S. central bank.

# I. PRINCIPLES OF THE FEDERAL RESERVE SYSTEM

## *A. Overview of the Federal Reserve System*

*"The Federal Reserve System – is the central bank of the United States."*[2] Congress founded it in late 1913, through enacting the Federal Reserve Act, which was subsequently approved by President Woodrow Wilson, the U.S. President at the time.[3] The Fed commenced its activities in 1914, and so far it is the most successful and efficient financial regulatory institution ever established in the United States.[4] Creation of the Fed was stipulated by the necessity of centralized regulation of financial system, which became obvious after the Banking panic of 1907.[5] The Federal Reserve Act defines the purposes of the Fed as follows: "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."[6]

The current banking legislation of the U.S. vested the Fed with following duties:

1) Performing national monetary policy focused on such economic goals as "maximum employment, stable prices, and moderate long-term interest rates;"[7]
2) Overseeing banking institutions and regulating financial system of the country;[8]
3) Securing stability of the financial system;[9]

[2] Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions p. 1 (2005), http://www.federalreserve.gov/pf/pdf/pf_complete.pdf (last visited Nov. 25, 2015).
[3] *Id.* at 1-2.
[4] *Id.* at 11.
[5] Myron T. Herrick, *The Panic of 1907 and Some of Its Lessons*, 31(2) Annals of the Am. Acad. of Pol. and Soc. Sci., 8, pp. 8–25 (1908).
[6] *See* 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, Public Law 63-43, 63d Congress, H.R. 7837 (1913), https://fraser.stlouisfed.org/scribd/?title_id=966&filepath=/docs/historical/fr_act/nara-dc_rg011_e005b_pl63-43.pdf#scribd-open (last visited Nov. 25, 2015).
[7] *See* Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra note* 2.
[8] *Id.*
[9] *Id.*

4) Furnishing financial services to a number of specific recipients, including the U.S. government, internal and external (foreign) financial institutions, and etc.[10]

The Fed is a very powerful financial regulator, which is entitled to adopt independent decisions within the scopes of its competences, stipulated by national objectives of economic and financial policy.[11] None of the representatives of the executive branch, including the U.S. Secretary of the Treasury, or even a President of the United States, is authorized to influence on or disapprove the decisions of the Fed.[12] However, the latter is accountable to the Congress, and has to maintain transparency in the governing of the financial system.[13]

### *B. Structure of the Federal Reserve System*

Pursuing the economic prosperity of the nation, the U.S. Congress structured the Fed as a system of the following agencies:

a) the Board of Governors ("the Board" or "the Governors");[14]
b) twelve regional Federal Reserve Banks ("the Reserve Banks");[15]
c) the Federal Open Market Committee;[16]
d) In addition to the foregoing major bodies, there are also two auxiliary elements of the System:
e) the Depository Institutions (Member Banks);[17] and
f) the Federal Advisory Committees (Councils).[18]

The central agency of the System is, of course, the Board, which together with the Federal Reserve Banks controls and regulates the proper operation of financial system.[19]

The Federal Open Market Committee ("the FOMC") is another crucial element of the System. It supervises financial activities in the open market.[20] This function is the main instrument used by the Fed to regulate monetary policy.[21] The FOMC consists of twelve Members, who are appointed out of the

[10] *Id*. at 3.
[11] William J. McDonough, *An Independent Central Bank in a Democratic Country: The Federal Reserve Experience*, 19 FRBNY Q. Rev. 1, pp. 2-4 (Spring, 1994).
[12] *See* Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at pp. 2-3.
[13] *Id.*
[14] Federal Reserve Act, 12 U.S.C. § 241-252 (2006).
[15] 12 U.S.C. § 225.
[16] 12 U.S.C. § 263.
[17] 12 U.S.C. § 342.
[18] 12 U.S.C. § 261-262.
[19] *See* Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at p. 3.
[20] 12 U.S.C. § 263.
[21] *See* Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at pp. 3-4.

members of the Board and the Reserve Banks, as follows: a) seven Members of the Board; b) the president of the Federal Reserve Bank of New York, and c) four rotating members - the presidents of other Federal Reserve Banks.[22]

The Fed governs monetary policy through regulating the federal funds rate —the rate at which banks make loans to each other from their balances held at the Federal Reserve.[23] The Federal Reserve performs this function through application of following regulatory tools:

1) Open market operations — trading with government bonds and securities in the open market "to influence the level of balances that depository institutions hold at the Federal Reserve Banks"[24]. As can be seen from the very name of this tool, the Fed buys and sells government bonds only in the open market, since the law prohibits the latter from trading directly with the U.S. Department of the Treasury that actually issues the government bonds[25] (also called Treasury bonds)[26]. The Federal Reserve Bank of New York is authorized by the FOMC to conduct open market transactions on behalf of the Federal Reserve.[27] In order to ensure the permanent ability to buy and sell securities, the Federal Reserve Bank of New York trades mainly with its major financial counterparts[28] from the approved list of primary dealers.[29] The primary dealers hold their respective accounts at the Federal Reserve Bank of New York, and are required to comply with the "capital standards of their primary regulators and satisfy other criteria consistent with being a meaningful and creditworthy counterparty."[30] As to the very trading process, the Federal Reserve Bank of New York purchases and sells the government bonds through the QE auctions.[31] The initial prices for the securities are

[22] *Id*.
[23] *Federal-Funds Rate*, Black's Law Dictionary (10th ed. 2014).
[24] See Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at p. 3.
[25] 12 U.S.C. § 355(1).
[26] *Treasury Bond*, Black's Law Dictionary (10th ed. 2014); *Treasury Bond – T-Bond*, INVESTOPEDIA, http://www.investopedia.com/terms/t/treasurybond.asp?layout=orig (last visited Nov. 25, 2015).
[27] *See* Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at p. 37.
[28] *See* Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at pp. 37-38.
[29] For the current primary dealers list *see Primary Dealers List*, FED. RES. BANK of N. Y., https://www.newyorkfed.org/markets/pridealers_current.html (last visited Nov. 25, 2015).
[30] *Id*.
[31] Zhaogang Song and Haoxiang Zhu, Divisions of Research & Statistics and Monetary Affairs, Bd. of Governors of the Fed. Reserve Sys., QE Auctions of Treasury Bonds 1, (2014). "QE auctions—a series of multi-object, multi-unit, and discriminatory-price auctions, conducted with primary dealers recognized by the Fed," http://www.federalreserve.gov/pubs/feds/2014/201448/201448pap.pdf (last visited Nov. 25, 2015).

stipulated by demand in the open market and supply conditions.[32] If the Fed decides to increase the money supply (for regulatory purposes), then it purchases Treasury bonds from the securities dealers, "who sell the bonds with cash" and, accordingly, "increases the overall money supply in the economy".[33] As a result of this additional money injection into the economy, the interest rate (or the cost of borrowing) in the banking system declines, since the overall availability and accessibility of money in the market increases substantially.[34] When the decline in the interest rate goes beyond the target range established by the FOMC, then the Fed may decide to decrease the money supply.[35] For this purpose, the Fed will sell government securities from its account, "thus taking in cash and removing money from the economic system."[36] As opposed to the consequences of buying the bonds, here as an effect of sale, the money supply will decrease causing an upsurge of interest rates.[37]

2) Reserve requirements — the specified amount of funds (usually in the form of cash), which depository institutions are required to hold in their vault against potential claims of customers.[38] The Fed is authorized by law to change the required reserve ratios and, thus, to adjust the latter to its regulatory needs and purposes.[39] When the Fed wants to decrease money supply, it increases the required reserve ratios so that banks are compelled to hold more deposits in their vaults and consequently have less money lend to their customers.[40] As a result the borrowing costs (or the interest rates) begin to increase.[41] Conversely, when the Fed decreases the required reserve ratios, banks are allowed to release some additional money from their vaults and use them for lending or other interest bearing financial purposes.[42] Accordingly, while the overall money supply in the economy is increased, the interest rates start gradually declining.[43]

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[32] *Why doesn't the Federal Reserve just buy Treasury securities directly from the U.S. Treasury?*, Bd. of Governors of the Fed. Reserve Sys., http://www.federalreserve.gov/faqs/money_12851.htm (last visited Nov. 25, 2015).
[33] Chris Gallant, *How do central banks inject money into the economy?*, INVESTOPEDIA, http://www.investopedia.com/ask/answers/07/central-banks.asp (last visited Nov. 25, 2015).
[34] *Id.*
[35] *Id.*
[36] *Id.*
[37] Reem Heakal, *How The U.S. Government Formulates Monetary Policy?*, INVESTOPEDIA, http://www.investopedia.com/articles/04/050504.asp (last visited Nov. 25, 2015).
[38] See Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at p. 3.
[39] 12 U.S.C. § 461.
[40] *See* Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra note 2*, at pp. 41-42.
[41] *Id.*
[42] *Id.*
[43] *Id. at 43.*

3) Contractual clearing balance requirement — financial reserve that depository institutions are recommended to hold in their Federal Reserve accounts in addition to the required reserve balance.[44] The purpose behind this requirement is to increase safety and soundness of the financial system and to facilitate possible clearing[45] needs of member banks.[46]

4) Discount window lending—is another tool of regulating monitory policy, which allows depository institutions to borrow money from the Federal Reserve at a discount rate for the purpose of addressing their liquidity issues.[47] Every Federal Reserve Bank is entitled to change the discount rate for its discount window ("subject to review and determination of the Board of Governors")[48]; thus, making borrowing from federal funds more or less expensive or, in other words, more or less accessible.[49] So, for instance, when the Federal Reserve Bank increases the discount rate, member banks try to abstain from borrowing money from discount window.[50] Therefore, member banks have less money to lend and the overall money supply in the economy decreases, entailing an increase in the federal funds rate.[51] In contrast, by decreasing the discount rate, the Fed makes the cost of borrowing from the discount window less expensive and, accordingly, more attractive for the banks.[52] This, in turn, causes the reduction in the federal funds rate, which stimulates transfers and circulation of large volumes of money among financial institutions.[53] Through these larger money circulation and affordable borrowings, banks obtain more money to lend their clients and, consequently, inject more money in the economy.[54]

Two other elements of the System also play a very important role in its operation and, along with other duties, are responsible for transmitting the

[44] *Id.* at p. 3.
[45] *Clearing*. Black's Law Dictionary (10th ed. 2014). The exchanging of checks and balancing of accounts [through debiting the account of check issuer and crediting the account of beneficiary].
[46] *See* Reserve Requirements for Depository Institutions, 74 Fed. Reg. 25,620, 25,622 – 25,629 (May 29, 2009) (to be codified at 12 C.F.R. pt. 204).
[47] *See* Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra note* 2, at pp. 2-3.
[48] 12 U.S.C. § 357.
[49] *Discount Window Lending*, Bd. of Governors of the Fed. Reserve Sys., http://www.federalreserve.gov/newsevents/reform_discount_window.htm (last visited Nov. 25, 2015).
[50] *Id.*
[51] *Id.*
[52] *See* Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra note* 2, at p. 33.
[53] *Id.*
[54] *Id.*

monitory policy to the financial markets (depository institutions),[55] as well as advising the System's major bodies different concerning specific aspects and demands of the financial system (Federal Advisory Committees).[56]

### *1. Board of Governors*

Being established in accordance with the Congressional Statute (Federal Reserve Act, 1913), the Board of Governors is "an independent entity within a federal government."[57] The "independence" of the Fed is restricted by the nation's primary macroeconomic objectives, such as, maximum employment and price stability, set by the Congress.[58] In this regard, it is often said that the Federal Reserve has only limited *goal independence*, and rather broad *instrument independence*.[59] For instance, the Fed, cannot sacrifice the price stability in order to decrease unemployment level (or to pursue any other economic objective).[60] At the same time, the vagueness of the objectives (e.g. maximum employment) leaves to the System a large room for interpretation and, thus, increases its goal independence.[61] The Federal Reserve enjoys full instrument independence and, in this sense, is free to choose the economic methods and tools by which it intends to accomplish its goals.[62] The general idea behind the independence of the Federal Reserve is that the decisions of the nation's central financial regulator should not be politically motivated, rather have to be based on rational judgement determined by the "laws of economics."[63] Throughout the wild economic upheavals of the 20th century,

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[55] Ann-Marie Meulendyke, Fed. Reserve Bank of N.Y, U.S. Monetary Policy and Financial Markets 57 (1998).

[56] *See* Wendy R. Ginsberg, *Federal Advisory Committees: An Overview*, Congressional Research Service 1-2, (2009), https://fas.org/sgp/crs/misc/R40520.pdf (last visited Nov. 25, 2015).

[57] *What does it mean that the Federal Reserve is "independent within the government?"*, Bd. of Governors of the Fed. Reserve Sys., (Jan. 9, 2015), http://www.federalreserve.gov/faqs/about_12799.htm.

[58] Fed. Reserve Bank of St. Louis, In Plain English: Making Sense of The Federal Reserve 16 (2013), https://www.stlouisfed.org/~/media/Images/Education/In%20Plain%20English/PDFs/In_Plain_English.pdf (last visited Nov. 25, 2015).

[59] Guy Debelle & Stanley Fischer, *How Independent Should a Central Bank Be?*, *in* Goals, Guidelines, and Constraints Facing Monetary Policymakers 197, (Jeffrey C. Fuhrer ed., 1994).

[60] *Id.*

[61] Carl E. Walsh, *Central Bank Independence*, *in* 1 The New Palgrave Dictionary of Economics 729 (Steven N. Durlauf & Lawrence E. Blume eds., 2d ed. 2008), http://people.ucsc.edu/~walshc/MyPapers/cbi_newpalgrave.pdf (last visited Nov. 25, 2015).

[62] *See* Debelle & Fischer, *supra* note 59.

[63] Lorenzo Bini Smaghi, *Central bank independence*, Speech at the "Good Governance and Effective Partnership" conference in Budapest, Hungarian National Assembly (Apr. 19, 2007), https://www.ecb.europa.eu/press/key/date/2007/html/sp070419.en.html (last visited Nov. 25, 2015).

the concept of the "independent central bank" has proved to be efficient, and currently is successfully applied by the world's strongest economies.[64]

The Board is comprised of the seven members, of whom "at least 1 member with demonstrated primary experience [in banking area]", appointed by the U.S. President and subject for the Senate's approval.[65] With the consent of the Senate, every four year the President also designates one Chairman and two Vice-Chairmen of the Board, selecting them out of active Governors.[66] The Board members serve for the period of 14 years and cannot be reappointed for the second term.[67] Their mandates are staggered, so that the term of one Governor expires every two years.[68] Such organization helps to limit the influence of the U.S. President to the Board's decisions, "making it unlikely that any President would be able to dominate the Board with a majority of his own appointees until near the end of his own second four-year term in office." [69] Moreover, once having appointed, the President cannot dismiss the Governors from their positions; therefore, the latter enjoy broad functional independence and may ignore or even oppose the President's view regarding the monetary policy issues.[70] The Federal Reserve also benefits from the privilege of being self-financing agency, generating its income from several payments of member banks and, thus, is financially independent from the Congress.[71] However, compared to the U.S. President, the Congress possesses larger competence to check and influence on the Board's decisions.[72] The Congress not only participates in the process of granting the Governor's mandates, but also hears the annual reports of the Board's Chairman on the Federal Reserve operations.[73] The Congress may discuss, criticize and express its recommendations concerning System's activities.[74] Although, the Fed is not obliged to follow Congressional opinion, it must act carefully in this regard, since the Congress retains the power to impeach the Governors, to alter the

[64] *Central bank*, New World Encyclopedia (last modified Apr. 28, 2013), http://www.newworldencyclopedia.org/entry/Central_bank (last visited Nov. 25, 2015).
[65] 12 U.S.C. § 241.
[66] 12 U.S.C. § 242.
[67] *Id.*
[68] *Id.*
[69] Paul M. Johnson, *Federal Reserve System*, A Glossary of Political Economy Terms, https://www.auburn.edu/~johnspm/gloss/federal_reserve_system (last visited Oct. 17, 2015).
[70] *Id.*
[71] *Where does the Federal Reserve get the money to fund its operations?*, Fed. Reserve Bank of S.F. (2006), http://www.frbsf.org/education/publications/doctor-econ/2006/may/federal-reserve-funding (last visited Nov. 25, 2015).
[72] Johnson, *supra* note 69.
[73] 12 U.S.C. § 247.
[74] Johnson, *supra* note 69.

Fed's statutory responsibilities, or even to entirely eliminate the Federal Reserve System through simple majority vote in both chambers.[75]

The Federal Reserve Act vests the Board with a very wide range of, so called, "enumerated powers,"[76] which determine the following primary responsibilities of the Board: a) to control and supervise financial institutions operating within the system; b) to coordinate activities of supervised financial institutions; c) to examine accounts and affairs of financial institutions; and etc.[77] In order to properly fulfil its duties and deliver prudent decisions, the Board of Governors conducts comprehensive analysis of modern trends and achievements in such areas as economics and finance.[78] Moreover, the Board "oversees and regulates the operations of the Federal Reserve Banks, and exercises broad responsibility in ensuring proper operation of the nation's payments system."[79] It supervises the in-country activities of nearly "900 state-chartered member banks and 5,000 bank holding companies"[80], as well as their out of the U.S. operations.[81] It worth noting that the Board is also authorized to inspect the nonbank subsidiaries of the bank holding companies, such as mortgage companies[82] (to ascertain the effects and repercussions of financial transactions between nonbank and bank subsidiaries of the bank holding companies).[83] Alongside, foreign financial institutions operating in the U.S. are also subjected to the Board's supervision.[84] In order to correct existing regulatory deficiencies, Title III of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("the Dodd-Frank Act")[85], further extended powers of the Board, transferring to the latter "the supervisory functions of the Office of Thrift Supervision (OTS)

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[75] *Id.*

[76] 12 U.S.C. § 248.

[77] *See* Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at p. 4.

[78] *Id.*

[79] *Id.*

[80] *Bank Holding Company*, Black's Law Dictionary (10th ed. 2014). A company that owns or controls one or more banks. Ownership or control of 25 percent is usually enough for this purpose.

[81] *See* Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at p. 4.

[82] Div. of Banking Supervision and Regulation, Bd. of Governors of the Fed. Reserve Sys., Supplement 46 to the Bank Holding Company Supervision Manual 1 (July, 2014), http://www.federalreserve.gov/boarddocs/supmanual/bhc/bhc.pdf (last visited Nov. 25, 2015).

[83] *Bank Holding Company Supervision Manual*, Bd. of Governors of the Fed. Reserve Sys., http://www.federalreserve.gov/boarddocs/supmanual/supervision_bhc.htm (last visited Nov. 26, 2015).

[84] *See* Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at p. 4.

[85] 12 U.S. Code § 5412.

related to [Savings and Loan Holding Companies] SLHCs and their non-depository subsidiaries beginning on July 21, 2011."[86]

Some of the Board's regulations are binding for the whole banking system, while its other acts touch only member banks (state banks that have opted to join the System) and national banks (required to be the Fed's members in accordance with law).[87] Governors are in permanent contact with other key governmental officials.[88] Quite often, congressional committees listen to the Governor's reports and testimonies concerning various financial issues and the potential economic impact of the drafted bills.[89] According to the Federal Reserve Act, the Vice Chairman semi-annually testifies before the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services concerning "the efforts, activities, objectives, and plans of the Board with respect to the conduct of monetary policy", as well as regulation of financial institutions and future projections in this regard.[90] In order to ensure the public accountability and transparency in the operation of the System, the Law requires the Board of Governors "to order an annual independent audit" of its own financial statements and those of Reserve Banks.[91] The audit is conducted by one of the major public accounting firms, and the final audit report together with other relevant materials is included in the Annual Report of the Board of Governors, which is subsequently submitted to the consideration of the Congress.[92]

***2. Federal Reserve Banks***

The Board of Governors controls and regulates the banking system of the United States through the network of twelve Federal Reserve Banks[93] and their twenty-four Branches.[94] Reserve Banks perform a wide range of Fed's functions, as to "operating a nationwide payments system, distributing the nation's currency and coin, supervising and regulating member banks and

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[86] *Supervision of Savings and Loan Holding Companies (SLHCs)*, Supervision and Regulation Letters, Bd. of Governors of the Fed. Reserve Sys., http://www.federalreserve.gov/bankinforeg/srletters/sr1111.htm#Footnote1 (last visited Nov. 26, 2015).

[87] *See* Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at p. 4.

[88] *Id.*

[89] *Id.*

[90] 12 U.S.C. § 247b.

[91] 12 U.S.C. § 248b.

[92] 12 U.S.C. § 247; Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at p. 6.

[93] *Id*.

[94] Bd. of Governors of the Fed. Reserve Sys., Annual Report: Budget Review p. 1 (2013), http://www.federalreserve.gov/publications/budget-review/files/2013-budget-review.pdf (last visited Nov. 26, 2015).

bank holding companies, and serving as banker for the U.S. Treasury."[95] Furthermore, each Reserve Bank accepts, holds and manages the deposits of the member banks that operate in its District.[96]

The Reserve Banks carry out the foregoing functions within the boundaries of their specific geographic area, the so called the Federal Reserve Districts.[97] Each District labeled with its specific number and the appropriate letter of the alphabet (e.g. 1 A – is a District of the Federal Reserve Bank of Boston, 2 B – New York, 12 L – San-Francisco, and etc.).[98] One may find these "requisites" reflected on the national currency (usually, below the serial number of the bill).[99] This reflection indicates on the respective Reserve Bank, which issued that particular banknote and accounts for it. For instance, the banknote with the requisite of "3 C" on it was issued by the Federal Reserve Bank of Philadelphia and appears on the balance sheet of the latter.[100]

The Board oversees the proper performance of major functions of the Federal Reserve Banks and their Branches, as well as examines compliance their activities to the standards established by laws and regulations.[101] This supervision and the examinations mainly concern the services rendered by the Federal Reserve Banks' to respective financial institutions.[102] However, more frequently activities of separate banking institutions are also becoming a subject of the Board's direct oversight.[103] Another form of the Board's supervision over the Federal Reserve Banks is the requirement for the latter to submit annual budgets for getting the Board's approval.[104]

The Congress also oversees the proper functioning of the Federal Reserve Banks as part of their supervision of the Federal Reserve System.[105] Among other things, the Congress usually pays special attention to the particular goals behind actions of the Federal Reserve Banks, since the latter were exclusively chartered by the Congress for a public purpose, so that they

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[95] Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at p. 6.
[96] *Id.*
[97] Bd. of Governors of the Fed. Reserve Sys., Annual Report: Budget Review, *supra* note 94, at 47.
[98] Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at pp. 7-9.
[99] Fed. Reserve Bank of St. Louis, In Plain English: Making Sense of The Federal Reserve *supra* note 58, at p. 8.
[100] *Id.*
[101] Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at pp. 10-11.
[102] *Id.*
[103] *Id.*
[104] *Id.*
[105] *Id.*

cannot pursue any private interests.[106] This becomes especially important, as the Federal Reserve Banks "combine both public and private elements in their makeup and organization."[107]

The Law provides that "[e]very Federal Reserve Bank shall be conducted under the supervision and control of a board of directors."[108] In total, the board shall consist of nine directors selected outside the particular Reserve Bank.[109] The Law divides the board of directors into three Classes (A, B, and C), [110] intended to establish cross-sectional representation of such areas as "banking, agriculture, commerce, industry, services, labor, and consumers."[111] Three directors of Class A shall be selected by and out of representatives of commercial (stockholding) banks that are members of the Fed.[112] Therefore, Class A designated to represent both banking sector and private interest in regulation of banking system.[113] Class B and Class C directors designated to represent all other sectors specified by law and pursue public interests.[114] Member banks of the Fed choose Class A and Class B directors,[115] while the Board of Governors appoints Class C directors.[116] The Board of Governors, further, shall designate one of Class C directors as the chairman of the board of directors and as the "Federal reserve agent"[117] The latter regularly reports to the Board of Governors on current issues and activities of the particular Federal Reserve Bank and the respective board of directors.[118] In this capacity, the chairman shall act as an "official representative" of the Board.[119]

Another crucial position in the structure of the Federal Reserve Banks is a position of the president, who acts as a chief executive of the Reserve Bank.[120] The Dodd-Frank Act changed the appointment procedure for the presidents

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[106] *Id.*
[107] *Id.*
[108] 12 U.S.C. § 301.
[109] 12 U.S.C. § 302.
[110] *Id.*
[111] Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at p. 10.
[112] 12 U.S.C. § 302.
[113] Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at p. 10.
[114] 12 U.S.C. § 302.
[115] 12 U.S.C. § 304.
[116] 12 U.S.C. § 305.
[117] *Id.*
[118] Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at 10.
[119] 12 U.S.C. § 305.
[120] *Federal Reserve Bank Presidents*, Bd. of Governors of the Fed. Reserve Sys., http://www.federalreserve.gov/aboutthefed/bios/banks/default.htm (last visited Nov. 26, 2015).

of the Federal Reserve Banks.[121] If earlier the entire board of directors selected the Federal Reserve president, and this selection had to be approved by the Board of Governors,[122] now the Reserve Bank presidents are appointed by a vote of only the Class B and Class C directors with a subsequent approval of the Board of Governors.[123] The main purpose behind the exclusion of the Class A directors from the appointment of the Reserve Bank presidents, was the desire of Congress to reduce the overall influence of bankers to the selection process, as well as to prevent "potential conflicts of interest that could arise from bankers participating in the selection of the leadership of their federal bank supervisor."[124] The Branches of Reserve Banks have their own board of directors comprised of three to seven members.[125] The Branch's Reserve Bank appoints the majority of those directors, and the Board appoints remained members.[126]

The Federal Reserve Banks through their boards of directors collect important "information on economic conditions from every corner of the country" and subsequently convey it to the Fed.[127] This information reflects the reports of the Reserve Bank directors and Branch directors, interviews with major business persons, economists, financial experts and other reliable sources.[128] The Board of Governors and the FOMC analyze this information and use it in making crucial decisions on monetary policy.[129] The Federal Reserve System also shares this information with the public through the so-called *Beige Book*, which is published eight times a year.[130] The Beige Book includes the reports of all the Federal Reserve Banks on current economic conditions in their respective district.[131] The board of directors of each Federal Reserve Bank is authorized to propose the interest rate for its Reserve Bank's

[121] Peter Conti-Brown and Simon Johnson, Peterson Institute for International Economics, Governing the Federal Reserve System after the Dodd-Frank Act, (Pol'y Brief, Oct. 2013), https://www.piie.com/publications/pb/pb13-25.pdf (last visited Nov. 26, 2015).
[122] *Id.*
[123] 12 U.S.C.A. § 341.
[124] Bd. of Governors of the Fed. Reserve Sys., DIRECTORS – Appointment of Reserve Bank Presidents and First Vice Presidents,
http://www.federalreserve.gov/aboutthefed/directors/PDF/appointment-of-reserve-bank-presidents-first-vice-presidents.pdf (last visited Nov. 25, 2015).
[125] Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at p. 10.
[126] *Id.*
[127] *Id.*
[128] *Beige Book,* Bd. of Governors of the Fed. Reserve Sys.,
http://www.federalreserve.gov/monetarypolicy/beigebook/ (last visited Nov. 26, 2015).
[129] Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at pp. 10-11.
[130] *Beige Book,* Bd. of Governors of the Fed. Reserve Sys., *supra* note 128.
[131] Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at pp. 10-11.

discount window.[132] However, the discount rates subsequently shall be reviewed and approved by the Board of Governors.[133]

***3. Federal Open Market Committee***

As it was mentioned above, the principal function of the FOMC refers to oversight of open market operations, which is the Fed's main instrument in regulation of the U.S. monetary policy.[134] In general, the open market operations determine how much money financial institutions can get from the Federal Reserve balances, and in this regard affect "overall monetary policy and credit conditions."[135] Another major task of the FOMC is conducting financial operations initiated by the Fed in foreign exchange markets.[136]

The FOMC is comprised of twelve members, of whom seven are the members of the Board of Governors and five are the Federal Reserve Bank presidents.[137] The president of the Federal Reserve Bank of New York serves as the FOMC member on a permanent basis, while each of other four presidents serve one-year rotating term.[138] Though all the FOMC members actively participate in the committee's discussions of major financial issues, economic trends and policy variations, only five members who are the Federal Reserve Banks' presidents are allowed to vote on policy decisions.[139] The members of the FOMC through internal voting elect their chairman and vice-chairman, however, according to the established tradition, the Chairman of the Board of Governors and the president of the Federal Reserve Bank of New York are elected to the mentioned positions respectively.[140]

***4. Member Banks***

All the U.S. commercial banks can be broken into three groups according to their relations with the Federal Reserve System.[141] The first group consist of the national banks chartered by the federal government. [142] These banks automatically get membership in the Federal Reserve System as prescribed by law.[143] The second group includes state chartered banks, which subsequently

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[132] Brian F. Madigan and William R. Nelson, *Proposed Revision to the Federal Reserve's Discount Window Lending Programs,* 88 Fed. Res. Bull. 313, p. 316 (July, 2002).

[133] *Id.*

[134] Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at pp. 11-12.

[135] *Id.*

[136] *Id.*

[137] 12 U.S.C. § 263(a).

[138] *Federal Open Market Committee*, Bd. of Governors of the Fed. Reserve Sys., http://www.federalreserve.gov/monetarypolicy/fomc.htm (last visited Nov. 25, 2015).

[139] 12 U.S.C. § 263(a).

[140] Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at pp. 11-12.

[141] *Id.* at p. 12.

[142] *Id.*

[143] *Id.*

opted to become a member of the Fed (state member banks).[144] The third group is comprised of other state banks, which decided not to join the Fed or simply cannot meet the requirements of the Fed (state non-member banks).[145] As can be seen, the law does not require state banks to obtain the Fed's membership, rather they are free to elect this prerogative, if they can comply with the Fed's standards.[146] Member banks shall "subscribe to the stock of the Federal Reserve bank [in the amount of 6 percent of their capital and surplus] organized within the district in which the applying bank is located."[147] This subscription (or purchase) is basically a legal condition of having membership in the Fed.[148] Member banks cannot sell subscribed stocks or use them as collateral for business transactions.[149] Similarly, the Federal Reserve Banks are also prohibited to sell their stocks to "individuals or entities other than member banks."[150] Regarding member banks, the law additionally provides that they shall receive the annual dividends in the amount of 6 percent on those subscribed stocks,[151] and also shall have a right to vote for Class A and Class B directors of their respective Federal Reserve Banks.[152]

### *5. Advisory Committees*

Advisory Committees play a very important role in ensuring the proper functioning of the Federal Reserve System by advising the latter on various significant issues.[153] Out of nearly 1,000 active committees[154] only three are entitled to advise the Board of Governors directly[155]:

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144 *Id.*

145 *Id.*

146 The membership requirements for the state banks are envisaged in the 12 U.S.C. § 321 – 339(a).

147 12 U.S.C. § 282, 321.

148 Bob Eisenbeis, *Dividends on Federal Reserve Stock and Highway Funding*, Cumberland Advisors, http://www.cumber.com/dividends-on-federal-reserve-stock-and-highway-funding/ (last visited Oct. 8, 2015).

149 Pam Martens, *Kill This Entitlement Program: The 6% Risk-Free Dividend the Fed Has Been Paying Wall Street Banks For Almost a Century*, Wall Street On Parade (Nov. 4, 2012), http://wallstreetonparade.com/2012/12/kill-this-entitlement-program-the-6-risk-free-dividend-the-fed-has-been-paying-wall-street-banks-for-almost-a-century/.

150 Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at pp. 11-12.

151 Martens, *supra* note 149.

152 Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at pp. 11-12.

153 *Id.* at p. 13.

154 Wendy R. Ginsberg, *The Federal Advisory Committee Act: Analysis of Operations and Costs*, Congressional Research Service 7 (Oct. 27, 2015), https://www.fas.org/sgp/crs/secrecy/R44248.pdf (last visited Nov. 25, 2015).

155 *Advisory Councils*, Bd. of Governors of the Fed. Reserve Sys., http://www.federalreserve.gov/aboutthefed/advisorydefault.htm (last visited Nov. 25, 2015).

• ***Federal Advisory Council -*** consists of representatives of all twelve Federal Reserve Districts, selected by the respective Federal Reserve Bank.[156] The representatives to the Federal Advisory Council are chosen annually, but as a tradition serve three one-year terms.[157] This council advises the Board on all range of responsibilities carried out by the latter and, in particular, regarding the current conditions in the banking industry and money supply issues.[158] The law requires the Federal Advisory Council to gather as minimum four times a year in Washington, D.C.[159]

• ***Community Depository Institutions Advisory Council ("the CDIAC")*** – is also composed of twelve representatives (one per Federal Reserve District), selected by the respective Federal Reserve Bank from local advisory councils.[160] The main task of the CDIAC is to provide oral and written representations to the Board on matters of "economy, lending conditions, and other issues of interest to community depository institutions."[161] Meetings of the CDIAC with the Board of Governors are held twice a year in Washington D.C.[162]

• **Community Advisory Council ("the CAC")** – is one of the youngest advisory committees established by the Board on January 16, 2015.[163] Unlike the Federal Advisory Council and the CDIAC, which represent depository institutions, the CAC is intended to represent consumers with a special emphasis on low-income and moderate-income population.[164] 15 members of the CAC are selected by the Board among the applicants who submitted their Statements of Interest in response to "the Board's public request for candidates."[165] The main qualification for the members of the CAC is a good knowledge and expertise in such areas as "affordable housing, community and economic development, small business, and asset and wealth building"

[156] *Federal advisory council*, 2 West's Fed. Admin. Prac. § 1808 (2015).

[157] Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve System: Purposes and Functions, *supra* note 2, at p. 13.

[158] *Id.*

[159] *Id.*

[160] Gavin Miller, *Community Banks, Fed Connect Through the Community Depository Institutions Advisory Council*, Cmty. Banking Connections, Fed. Reserve Sys., https://www.communitybankingconnections.org/articles/2012/q3/community-banks-connect-with-cdiac (last visited Nov. 28, 2015).

[161] *Community Depository Institutions Advisory Council*, Bd. of Governors of the Fed. Reserve Sys., http://www.federalreserve.gov/aboutthefed/cdiac.htm (last visited Nov. 28, 2015).

[162] *Id.*

[163] Solicitation of Statements of Interest for Membership on the Community Advisory Council, 80 Fed. Reg. 19,662 (Apr. 13, 2015), http://www.gpo.gov/fdsys/pkg/FR-2015-04-13/pdf/2015-08354.pdf (last visited Nov. 25, 2015).

[164] *Community Advisory Council*, Bd. of Governors of the Fed. Reserve Sys., http://www.federalreserve.gov/aboutthefed/cac.htm (last visited Nov. 28, 2015).

[165] Solicitation of Statements of Interest for Membership on the Community Advisory Council, 80 Fed. Reg. at 19,662.

and etc.[166] The Board of Governors plans to meet with the CAC twice a year in Washington.[167]

## II. FEDERAL RESERVE POLICIES CONTRIBUTED TO THE FINANCIAL CRISIS

Many academic and non-academic papers were written explaining a large number of reasons behind the Financial Crisis of 2008. Indeed, there are multiple factors which have triggered this financial disaster,[168] but the "guilt" of the Federal Reserve System in this regard seems much higher than that of any other contributor, since the prediction and prevention of such disasters is the direct duty of the country's central bank. The Fed began contributing to the Financial Crisis of 2008 much before the actual occurrence of the crisis, and even before the preceding *Dot-Com Crisis* of 2000. But let us first go to Japan.

In the late 1980s, the economy of Japan after decades of swift development started acquiring the symptoms of bubble economy.[169] One of the major reasons behind the formation of the so-called *Japanese asset price bubble* was a delayed response of the Bank of Japan ("the BoJ") and its erroneous monetary policy.[170] Too much liquidity in the economy and the low interest rates maintained by the central bank stimulated excessive economic activity that resulted in the ultimate overheating of the economy,[171] entailing artificial overinflation of real estate and stock market prices.[172] Trying to address the upcoming crisis the BoJ in a few steps tightened the monetary policy, raising the official discount rate from 2.5% in 1989 to 6% in 1990. Together with some additional measures applied by the BoJ,[173] this tightening policy increased the

[166] *Id.*
[167] *Id.*
[168] *The origins of the financial crisis,* The Economist (Sep. 7, 2013), http://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article (last visited Nov. 25, 2015).
[169] Thayer Watkins, *The Bubble Economy of Japan*, San Jose State University, http://www.sjsu.edu/faculty/watkins/bubble.htm (last visited Nov. 25, 2015).
[170] Barry Nielsen, *The Lost Decade: Lessons from Japan's Real Estate Crisis*, INVESTOPEDIA, http://www.investopedia.com/articles/economics/08/japan-1990s-credit-crunch-liquidity-trap.asp (last visited Nov. 29, 2015).
[171] Takatoshi Ito and Frederic S. Mishkin, *Two Decades of Japanese Monetary Policy and the Deflation Problem*, Monetary Policy under Very Low Inflation in the Pacific Rim, 15 NBER-EASE 131, 137 (2006), http://www.nber.org/books/ito_06-1 (last visited Nov. 25, 2015).
[172] Thayer Watkins, *supra* note 169.
[173] Takatoshi Ito and Frederic S. Mishkin, supra note at p. 171. ("In tandem with the interest rate hike, regulatory tightening was applied to stop increases in land prices including: limiting the increase in bank lending to real estate related projects and companies in the spring of 1990, and raising taxes on realized capital gains from land investment. Stock prices finally turned down from the first trading day of 1990. The stock price index declined by one-

cost of borrowing by more than 150%, thereby substantially decreasing the ability of consumers to repay their loans, and severely affecting financing of real estate related business projects.[174] As subsequent events revealed, these too late and too harsh measures failed have intended healing effect, rather they accelerated the actual collapse of the bubble causing one of the deepest and longest recessions in the history.[175]

The similar situation occurred in the United States in 1997, as a result of the unprecedented development of information technologies and internet boom of 1990s, where the IT (or Dot-Com) stock market was speculatively overvalued.[176] Not willing to repeat the Japanese scenario, the Fed through the "four monetary strikes" increased the federal fund's rate from 5.25% in 1999 to 6.5% in 2000 and the Dot-Com bubble collapsed.[177] The Fed acted much more careful than BoJ at the time and boosted interest rates just to an extent necessary to lash-out the bubble.[178] However, since the Fed failed to react timely, the bubble could still become sufficiently big to entail painful financial consequences, though less significant than in case of Japan.[179] The Dot-Com crisis was further aggravated by 9/11 events, and the Fed, in order to avoid a deeper recession, decided to undertake prompt measures to revive the economy.[180] For that purpose, the Fed dramatically decreased the target interest rate, at first to 1.75%, then to 1.25, and finally reaching the 1% rate in 2001, 2002 and 2003 respectively.[181] Thus, the economy indeed started

third from the end of 1989, the peak, to the end of 1990. Stock prices continued to decline and the index lost 60 percent of the peak level by the summer of 1992. Land prices started to decline in 1991. The bubble had burst.").

[174] *Id.*

[175] Peter Alford, *Japan headed for longest, deepest post-war recession*, THE AUSTRALIAN, http://www.theaustralian.com.au/business/latest/japan-headed-for-depression/story-e6frg90f-1111118867488 (last visited Nov. 25, 2015).

[176] Ben Beachy, *A Financial Crisis Manual: Causes, Consequences, and Lessons of the Financial Crisis*, GDAE Working Paper No. 12-06, Tufts University 8 (2012), http://www.ase.tufts.edu/gdae/Pubs/wp/12-06BeachyFinancialCrisis.pdf (last visited Nov. 25, 2015).

[177] Farrokh Langdana, *Federal Reserve Policy From the Dot-Com Bubble to the "Subprime Mess": A Story Of Two Ups and Two Downs*, 6 Rutgers Bus. L.J. 56, pp. 56-57 (2009). After several unsuccessful attempts to "'talk down' the market in 1996 with his 'irrational exuberance' comment, then [the Chairman of the Federal Reserve Alan Greenspan] was determined not to follow the path taken by Japan in the late 1980s", and did eventually undertake effective but still not seasonable preventive measures.

[178] *Id.*

[179] *Id.* After several unsuccessful attempts to "'talk down' the market in 1996 with his 'irrational exuberance' comment, then [the Chairman of the Federal Reserve Alan Greenspan] was determined not to follow the path taken by Japan in the late 1980s", and did eventually undertake effective but still not seasonable preventive measures.

[180] Langdana, *supra* note 177.

[181] *Historical Changes of the Target Federal Funds and Discount Rates,* FED. RES. BANK of N. Y., https://www.newyorkfed.org/markets/statistics/dlyrates/fedrate.html (last visited

growing again.[182] As an effect of low interest rates, loans became more affordable for the subprime borrowers, low-income customers or persons with below-than-average credit histories.[183] However, since this category of borrowers usually has no collaterals (assets) which could be used to secure the payment of a debt, banks were offering subprime loans mostly for a purpose of purchasing real estate (mortgage), thereby securing the loans by the very purpose of those loans.[184] However, the subprime mortgages also have another specific feature, which is an adjustable interest rate "that is low at inception, to help a financially weak borrower qualify, then rises over the life of the loan."[185]

After the "technology shock" of the preceding crisis, investors were seeking to purchase less risky assets and invest in more stable projects.[186] The collateralized debt obligations backed by mortgages seemed as perfect investment targets at that time, and investors were actively purchasing them. These bonds emerged as a result of "mortgage securitization"[187], the process where the mortgages of different risk categories (from high to low risk) are getting put and combined in one common "pool", and then being '''sliced and diced'- that is, some of the excellent mortgages (or parts of them) are combined with parts of the other categories of mortgages, [so that a resulting 'mortgage-backed security' composed of bits and pieces of many individual mortgages.]"[188] The major purpose behind securitization is that through this process financial institutions can substantially increase the liquidity of their illiquid assets, and a mortgage due to its financial nature is among the least

Nov. 29, 2015).

[182] *Post-Recession: Predicting the Next Growth Cycle*, SBC magazine, http://www.sbcmag.info/news/2014/jul/post-recession-predicting-next-growth-cycle (last visited Nov. 29, 2015).

[183] *Subprime Loan,* Black's Law Dictionary (10th ed. 2014).

[184] *Mortgage*, Black's Law Dictionary (10th ed. 2014).

[185] *Id.*

[186] William Poole, *Causes and Consequences of the Financial Crisis of 2007-2009*, 33 Harv. J.L. & Pub. Pol'y 421, p. 424 (2010).

[187] *Id*. at 425. "The federal government encouraged growth of the subprime mortgage market in an attempt to increase the percentage of families owning their own homes. Congress and the Bush Administration pushed the giant mortgage intermediaries, Fannie Mae and Freddie Mac, to accumulate subprime mortgages. Previously, Fannie and Freddie had dealt only in prime mortgages with a maximum loan-to-value ratio of eighty percent. The main business of these government-sponsored enterprises (GSEs) was to securitize prime mortgages into mortgage-backed securities, some of which they sold into the market and some of which they held in their own portfolios."

[188] Bruce D. Fisher, *A Simple Explanation of Some Legal and Economic Aspects of the Financial Meltdowns of Banks*, 89 Mich. B.J. 38, p. 39 (Mar. 2010).

liquid assets.[189] Usually, the creditor has to wait from 25 to 30 years to fully assume the benefits of a mortgage lending, whereas through securitization of mortgages the creditor may put the resulting securities on the market and get the mortgage benefits within days or even hours.[190]

When the consequences of the Dot-Com bubble started disappearing and the overall economic activity in the country reached the pre-crisis level and even went beyond, the Fed decided to increase the target federal funds rate, in order to cool down the economy.[191] Already, in June 2005, the rate increased to 3.25% and in June 2006 to 5.25%, and remained so until September 2007.[192] At this point, banks started readjusting subprime mortgages to a new higher interest rate. As a result, millions of subprime borrowers became incapable to duly perform their mortgage payments.[193] Some borrowers were substantially delaying the payments, while others were simply leaving the collateralized properties.[194] In response, banks began selling collaterals, most of which were private houses, and at some point, the offer in the private housing market exceeded the demand to such an extent that prices simply plummeted.[195] Price decline was so steep that creditors were unable to recover even their actual loans, thereby incurring huge losses.[196] Another major problem was the panic spread among the mortgage-backed securities holders, including foreign entities.[197] The panic began when the holders discovered that the mortgages combination behind each particular security or package of securities was too uncertain to effectuate full (if any) payments in case of mortgage default.[198] What property will be seized to disburse the debt that the mortgage secures? Is it a bathroom of the house that was sliced and diced during securitization or just a door into the bathroom?[199] What will happen, if only one of the portioned and blended mortgages defaulted, and the other mortgages from the same bundle were not? Investors were asking the same questions and were not given clear answers.[200] Mortgage defaults and foreclosures in

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189 *Securitization*, INVESTOPEDIA, http://www.investopedia.com/terms/s/securitization.asp?layout=orig (last visited Nov. 25, 2015).

190 Fisher, *supra* note 188.

191 Langdana, *supra* note 177, at p. 59.

192 *Historical Changes of the Target Federal Funds and Discount Rates*, *supra* note 181.

193 Randall S. Kroszner, *The Challenges Facing Subprime Mortgage Borrowers*, Speech at the Consumer Bankers Association 2007 Fair Lending Conference, Washington, D.C. (Nov. 5, 2007), http://www.federalreserve.gov/newsevents/speech/kroszner20071105a.htm.

194 *Id.*

195 Poole, *supra* note 186, at p. 426.

196 *Id.*

197 *Id.* at pp. 425-426.

198 *Id.*

199 Fisher, *supra* note 188, at p. 39.

200 *Id.*

tandem with founded panic among investors caused a dramatic decline in the value of the mortgage securities, "costing portfolio managers millions or billions of dollars in losses."[201] Since these "toxic securities" were purchased and repurchased not only by national, but also many international actors, the consequences of the U.S. subprime mortgages default affected almost all major economies of the world, entailing the global financial crisis.[202]

# CONCLUSION

Summarizing the Federal Reserve System's contributions to the financial crisis of 2008, the following major mistakes can be highlighted:

- *Failure to learn from Japanese asset price bubble experience.* The foregoing history of events shows that one minor regulatory mistake assumed in tackling the problem entails the whole chain of new problems which may +require more sophisticated approach. The Fed failed to make necessary conclusions from Japanese experience, and could not develop key risk indicators and proper risk assessment system to be able to address the emerging threats timely and effectively. Inability to seasonably handle the growing Dot-Com bubble eventually resulted in its collapse, putting the economy in recession. This fact compelled the Fed to substantially decrease the target federal funds rate to revive economy. The outcome seems clear: had not the Fed make a delay while tackling the Dot-Com bubble, there would be no need in such steep decline of federal funds rate in 2001.
- *Failure to set up the proper underwriting standards for subprime mortgages and to establish certain requirements for banks dealing with mortgage securitization.* The Fed had to be more attentive to the increasing market of subprime mortgages and their securitization. It should definitely ascertain whether this one of the fastest growing shares of the economy develops in a proper way, and should seasonably prevent the cases of gross negligence existing in the field of mortgage securities underwriting and securitization.
- *Failure to predict and prevent the re-pricing of subprime mortgages to higher interest rates effectuated by an increase in the target federal funds rate.* Once again, the Fed did not apply any necessary risk assessment measures and, accordingly, could not foresee the obvious consequences of its incorrect monetary policy. It would be most reasonable to undertake appropriate regulatory measures which would restrain the banks from

[201] Eamonn K. Moran, Wall Street Meets Main Street: Understanding the Financial Crisis, 13 N.C. Banking Inst. 5, p. 55 (2009).

[202] G20 summit: Barroso blames Eurozone crisis on US banks, The Guardian (June 18, 2012), http://www.theguardian.com/world/2012/jun/18/g20-summit-barroso-eurozone-crisis (last visited Nov. 25, 2015).

readjusting the subprime mortgage prices. As a result, the Fed would, if not prevent the crisis, then at least mitigate its consequences.

It is easy to look back after all these events and judge about the mistakes of the Fed, however, no one can guarantee that the Fed would be able to prevent the crisis, had it acted differently and implemented all the recommendations of its critics.