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CENTRAL BANKS AS REGULATORS AND SUPERVISORS OF THE FINANCIAL SYSTEM; PARALLEL BETWEEN THE AMERICAN FEDERAL RESERVE SYSTEM AND THE COLOMBIAN BANK OF THE REPUBLIC

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CHAPTER I
INTRODUCTION

One of the principal actors in the regulation of the economies around the world are the Central Banks. Central banks have the function of controlling price stability and managing the supply of credit and money. ¹ They also administered foreign reserves and are generally the government bankers. ² In some countries, the Central Bank also manages the exchange rates.

Since Central Banks hold the reserves from commercial banks and are lenders of last resort, they have certain responsibilities in the stability of the financial system.³ Sometimes they even have duties as regulators and supervisors of the financial system.

The role of Central Banks in national economies is more important every day. These entities have rapidly adjusted to new political and economical situations. Their existence is a very important issue of political sovereignty⁴. In today's economies, every nation needs a Central Bank to fulfill different duties that will produce a positive impact in its economy.

¹ Stanley Filcher, Modern Central Banking, Bank of England (1994). See also Paul A. Volker & Miguel Mancera and Jean Gordeux, Perspective On The Role Of A Central Bank, 17 MD. I.Int’l L.& Trade 141 (stating that the most important contribution of a central bank is to create price stability since it stimulates greater investment and savings, and promotes exchange rate stability).

² Id at 3.

³ Id.

Generally speaking, Central Banks are viewed with respect and admiration. Countries derive many benefits from having a respected, professional and solid bank.

This work is a comparative piece between the Federal Reserve System and the Bank of the Republic. In doing this comparison and before getting into more specific issues, one must take into account that there are structural differences between the United States and Colombia.

In the first place, the United States has a federal system composed of national and state powers while Colombia has a centralist system with powers mainly at the national level. The legal structure of each country is different since the United States is a common law system and Colombia is a civil law system. Another important consideration is that the United States is the economic power of the world while Colombia is a developing country.

The deductive method, going from the general to particular issues, will be used in this work. The reason for this approach is to give the reader a background of general matters related to central banking in the United States and in Colombia in order to make more comprehensible specific issues like supervision and regulation of the financial system by central banks.

The first part of this paper will focus on the origin and legal nature of the American Federal Reserve System established by the Federal Reserve Act of 1913 and Colombia's Bank of the Republic. Next, I will offer a deep study of the structure of the Federal Reserve System, concentrating on institutions like the Board of Governors, the Federal Reserve Bank, the Federal Open Market Committee, and member banks. I will also

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5 Id at 128.

6 Id.
describe and analyze Colombia's Bank of the Republic, placing emphasis on the reforms introduced by the new Constitution.

In Chapter IV the main faculties, functions and operations undertaken by each of these Central Banks will be briefly explained and described.

The following chapter will focus on the role of central banks as supervisors and regulators of the financial system, particularly in the United States and Colombia. In this segment, this paper will focus on other regulators and supervisors of the system and the areas in which the Central Bank of each country is empowered to regulate or supervise.

Finally, this study will concentrate on all the arguments in favor of and against regulations and supervision of the financial System by the central banks and the similarities and differences of the American and Colombian systems in these areas.
CHAPTER II
CENTRAL BANKS ORIGIN AND NATURE

A. United States Federal Reserve System

Before the enactment of the Federal Reserve Act, the supply of money and credit in the United States was irregular\(^7\) and the banking system had been subject to several crises, the strongest in 1907\(^8\). During these crises, the public demanded the gold and currency they had deposited in the banks. Banks were not prepared for these withdrawals and were forced to take extreme measures like asking for loans and selling their assets\(^9\).

In this context, Congress established the National Monetary Commission headed by Senator N.W. Aldrich to study the problems of the financial system and to formulate some remedies\(^10\). In 1912, the Aldrich commission recommended the adoption of a pure central bank with centralized reserves, centralized facilities, and centralized note issues.\(^11\) This model had been adopted in several European countries and was working in a very effective way\(^12\).

\(^7\) BOARD OF GOVERNORS OF THE FEDERAL, RESERVE SYSTEM: PURPOSES AND FUNCTIONS (6th ed. 1974) [hereinafter Purposes and Functions].

\(^8\) GL BACH, FEDERAL RESERVE POLICY-MAKING, (Alfred A. Knopf, 1st ed. 1950) [hereinafter Bach]

\(^9\) Id at 3.

\(^10\) Id.

\(^11\) Id.

\(^12\) Id.
Meanwhile, democrats in the Congress formed a Banking and Currency Committee to make a similar investigation. The subcommittee for banking reform was headed by the House of Representative Carter Glass. After studying the issue, this subcommittee concluded that a centralized central bank was not appropriate for the United States and recommended a district organization.

In the end of that year, Woodrow Wilson was elected president of the United States. President Wilson supported the Glass subcommittee approach with a few modifications. On September 18, 1913, the “Glass Bill”, with some changes, was approved by the House of Representatives. Afterwards, the Senate began its debates and discussion, coming up with their own draft. On December 23, the two versions were settled and signed by the President.

This act which created the Federal Reserve System is known as the Federal Reserve Act. The main purpose of the original act was to have an elastic currency, and a more effective banking system for supervision and facilities for rediscounting commercial papers. Another objective of the act was to promote the stability of the economy by regulating credit.

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13 BENJAMIN HAGGOT BECKHART, FEDERAL RESERVE SYSTEM, (American Institute of Banking ed. 1972) [hereinafter Haggot].

14 Id at 24.

15 Bach, supra note 8, at 3-4.

16 Id.

17 Haggot, supra note 13, at 24.

18 Id at 25. The Congress passed the Federal Reserve Act based on the power granted by the Constitution in article 1 Section 5 which empowers it “to coin money and regulate the value thereof”.

19 Functions and Purposes, supra note 7 at 1.

The act created a unique decentralized central bank structure organized in three levels: the Board of Governors, twelve regional Reserve Banks and Bank members.21 The legal nature of each is very different. The Board of Governors is a public entity with special characteristics that will be described in the next chapter, the Regional Reserve Banks are privately owned entities under federal supervision and the member banks are privately owned entities.22

The Federal Reserve System has developed throughout the years and has been amended several times in order to adapt to new political and economical circumstances.

B. Colombia's Bank of the Republic

Before 1923, banks that issued their own money existed in Colombia and attempts to create a central bank had failed. Economist and politicians discussed the possibility of the concentration of the issuing of money power in one bank or the total liberty for commercial banks to issue their own money.23

To avoid a crisis in the financial and monetary systems and to give more elasticity to currency, the necessity of a Central Bank was perceived24. In accordance with this, the government contracted a group of American banking experts, led by professor Edwin Kemmerer, which did a deep and exhaustive analysis and concluded that Colombia needed a Central Bank, along with financial and fiscal reform.25

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21 Id at 840.


23 JORGE ENRIQUE IBANEZ, EL BANCO DE LA REPUBLICA: ANTECEDENTES, EVOLUCION Y ESTRUCTURA( Banco de la Republica ed. 1993)[hereinafter Ibanez]

24 Id at 167-69.

Congress adopted Kemmer's suggestions and created The Bank of the Republic as an emission and deposit bank with the power of discount. The capital of the bank was divided in four kinds of stocks. Class A stocks represent 50% of the bank's capital and were owned by the government. Class B, C, and D stocks were owned by National Banks, Foreign Banks with business in Colombia and the public in general respectively and represent the other 50% of the bank's capital.

The original bank had a peculiar legal structure: it was an Anonymous Society created under commercial laws with public service functions granted by an administrative act which also authorized the bank to make emission of currency.

The instruments of monetary policy used by the bank were limited to discount operations. The Board of Directors of the Bank was composed of representatives of public and private sectors and was authorized to make and execute the monetary policy.

Several laws were passed by the Congress in order to amend the original act giving new powers to the bank like determining exchange rates, establishing reserve requirements to commercial banks, guard international reserves of the country, and give subsidy credit to some sectors of the economy.

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27 JAIME MARTINEZ RECAMAN, HISTORIA JURIDICA DEL BANCO DE LA REPUBLICA, (Banco de la Republica ed. 1980).

28 For the purposes of this note, these kind of entities are the equivalent to American Corporations.

29 Martinez, supra note 27, at 11.

30 Law 82 of 1931.

31 Legislative Decree 1407 of 1948.

32 Law 82 of 1931.

33 Decrees 384 and 1249 of 1950.
Between 1949 and 1951, the Board of Governors of the Federal Reserve System send two commissions to Colombia, one led by Lauchlin Currie and the other one by Richard Grove and Gerald Alter which. These commissions recommended the adoption of several instruments needed for the correct direction of monetary, credit and exchange policies and the development of the economy. Two government decrees adopted these recommendations and also authorized the government to sell its shares in the Bank of the Republic.

Since private bankers became owners of the Bank of the Republic, pressures were created in order to separate the policy making functions of the bank and give them to a government entity. In response to this problem, Congress issued the law 21 of 1963 which reformed the central banking system in Colombia. This law created the Monetary Board, a public entity composed of different members of the government, with the function of regulating all aspects related to monetary, credit and exchange policies. The Bank of the Republic continued to be privately owned and had the duty to execute all decisions and policies adopted by the Board.

Ten years later, Congress decided to Nationalize the Bank of the Republic and the government acquired 99.99% of the stocks. This decision ended the reason for the

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34 Martinez, supra note 27, at 61 (also stating that the bank acquire functions of a modern central bank and macroeconomics stabilizer).

35 See Decrees 756 and 2057 of 1951.


37 The Monetary Board was initially composed by the Ministers of Finance, Development and Agriculture, by the Director of the Department of National Planning, by the Director of the Colombian Institute for International Commerce and by the General Manager of the bank.

38 See Law 21 of 1923.

39 Id.

separation of the central bank since the Bank and the Monetary Board were public entities.

Under this system, the government had a very strong influence over these policies since the members of the Monetary Board were part of the same economic team.

In 1991, the Constitution of 1886 was replaced. The new Colombian Constitution introduce a radical and structural reform of the central bank system. As noted earlier, the origin and legal base of the Bank of the Republic was a law passed by the Congress. Drafters of the new Constitution gave the central bank constitutional status. In this way, the general provisions of the Colombian central banking system were established in the Constitution.

The 1991 Constitution eliminated the Monetary Board and created the Board of Directors of the Bank of the Republic. This Board has supreme monetary, exchange and credit authority. It also established the Bank of the Republic as the central bank, formed as a public legal person with administrative, patrimonial and technical autonomy.

The Constitution also empowered the Congress to pass a law which the Bank of the Republic has to respect while exercising its functions, and that gives the general parameters of the structure, functions and special legal system of the bank.

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41 Ibanez, supra note 23, at 538.
42 COLOM. CONST. t.XII, ch.6.
43 Id.
44 COLOM. CONST. art. 372.
45 COLOM. CONST. art. 371.
46 COLOM. CONST. art. 150 ord.13, ord. 19 lit.b, ord.22.
CHAPTER III

STRUCTURE AND INDEPENDENCE OF THE CENTRAL BANKS

A. Federal Reserve System

The Federal Reserve System is composed essentially by the Board of Governors, the Reserve Banks, the Bank Members and the Federal Open Market Committee. The system also counts with an Advisory Committee and other committees and conferences that have different objectives and purposes. Each of these components of the Federal Reserve System will be treated in these section.

1.- Board of Governors of The Federal Reserve

The bank’s Board of Governors of the Federal Reserve is a public entity\(^{47}\). In 1914, an opinion rendered by the Attorney General of the United States classified the Federal Reserve Board (today's Board of Governors of the Federal Reserve) as “an independent bureau, or establishment, and as such not under the jurisdiction of the Treasury Department”\(^{48}\). The important aspect of this opinion is the express recognition of certain independence of the Board from the government\(^{49}\), especially from the Secretary of Treasury which is the fiscal authority of the country.

\(^{47}\) Bernstein, supra note 22, at 112.

\(^{48}\) Haggot, supra note 13, at 24 (citing H. Parker Willis, The Federal Reserve System (New York: Ronald, 1923)). See also Functions and Purposes, supra note 7, at 3 (stating that the Federal Reserve System is “independent within the government”. This statement is based on the facts that decisions by the Board are not revisable by the president but the Board has certain duties like reports to the Congress and work within the general economic and financial objectives established by the government. Besides, President and Congress play an essential role in the appointing process).

\(^{49}\) The issue of Central Banks independence has been discussed in the past decades among economist and legal scholars. The independence refers to the relation of the Central Bank specially with the government but also with other branches of the public power. Independence is necessary, particularly from the government, in order to avoid interference that will affect in a negative way monetary stability in the long
This independence empowers the Board to act in accordance with its best judgment respecting the parameters and the sphere of action establish by the Congress in the law.\textsuperscript{50} The faculties and power’s possessed by the Board were obtained by delegation from the Congress in the Federal Act and its respective amendments.

A very important aspect for maintaining the independence of the Board is that their expenses are not part of the United States government budget and therefore are not considered government or appropriate funds\textsuperscript{51} and not subject to congressional revision\textsuperscript{52}. These funds are obtained from the Reserve Banks, they are considered public\textsuperscript{53} and can be expended in a discretionary way by the board\textsuperscript{54}. If congress had the power to vote the term. The most important topics related to central bank independence are the appointing process and term of board members, politics of loans to the government, supervision of the bank, government’s representation on the Board and patrimonial autonomy. The degree of independence depends on several factors like its constitutional or legal status, general public support and political, economical and social climate of the country. Most industrializes countries have central banks with some sort of independence. Recently, several countries have reform their central banks and established independence. See Alex Cukierman, The Economics of Central Banking, Paper Prepared for the Eleventh World Congress of the International Economic Association, December, 1995, Tunis, Tunisia at I[hereinafter Cukierman] (stating that since 1989 twenty five countries including Belgium, France, Italy, Spain, New Zealand, Argentina, Chile, Colombia, Russia, Ukraine, Bulgaria and Hungary have “substantially upgraded the legal independence” of their central bank). Independence of Central banks has provided a positive impact in the economies. See Cukierman (proving that in countries with independence of the Central Bank there are lower rates of inflation and equal or higher rates of growth). See also Bach, supra note 8, at 208-220 (commenting about the Federal Reserve independence). Several studies have demonstrated that a Central bank is not totally independent until it controls foreign exchange policies. See Roberto Junguito B. & Hernando Vargas, Central Bank Independence and Foreign Exchange policies in Latin America, IMF-Banco de la Republica, seminar on Central Bank Independence, Bogota, Feb.1996 at 7. See Alex Cukierman & Steven B. Webb, Political Influence on the Central Bank: International Evidence, The World Bank Economic Review, Vol. 9, No. 3, at 397-423 (1995) (demonstrating that political instability in a country causes instability in the central bank. Also commenting that on developed countries the legal establishment of central bank Independence is important to control inflation, and on developing countries the rotation of governors or directors of the central bank influences in a direct way the inflation rate).

\textsuperscript{50} Haggot, supra note 13, at 31.

\textsuperscript{51} \textit{Id}.

\textsuperscript{52} Aman, supra note 20, at 850.


\textsuperscript{54} Aman, supra note 20, at 850.
appropriation of funds for the Board, it would have a very big influence on the Federal Reserve policy and the independence would be restricted in a sensitive way.

The income and expenses of the Board are audited by independent certified public accounting firms. Each Reserve bank has an auditor that reports to the Board of Governors, and is also authorized to examine the accounts of these banks.

Regulation of the Board's monetary policy is practically not revisable by the Courts, and its other regulatory functions are so discretionary that the review is limited in an important way.

In order to control that the independence of the Board of Governors does not exceed its limits, each year it has to make a full report of all its operations and activities to the House of Representatives, and transmit a report on economic issues to Congress twice a year and publish a weekly statement.

In the original act, the Board was composed of five members appointed by the President and confirmed by the Senate for a period of ten years, with the Secretary of the Treasury and the Comptroller of the Currency acting as ex officio members. The Secretary of Treasury was the chairman of the Board and the President designated the Governor and vice-governor from the members (now called Chairman and Vice Chairman).

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55 Haggot, supra note 13, at 32.
56 Id at 31.
57 Id.
58 Aman, supra note 20, at 850-51.
60 Functions and Purposes, supra note 7, at 23.
61 Haggot, supra note 13, at 33.
62 Id.
Several modifications to the Board's structure took place during the 20's and 30's. The most important was the Banking Act of 1935 which modified the appointed members to seven and eliminated the ex officio members. Now there is no direct participation of the Government in the Board. This way, the Board became more independent from the Secretary of Treasury, one of the biggest borrowers of the system. This amendment also extended the term of the governors to fourteen years.

Today's Board of Governors consists of seven members appointed by the President with the advice and consent of the Senate. Members are appointed for a term of fourteen years and cannot be reappointed after completing a full term. The sequence of the terms of the members is design in such way that each two years a member term expires. This way the influence of the current government over the Board is lessen since each President appoints only two members. Additionally, the fourteen years term gives more stability to the policies and decisions adopted.

Members cannot come from the same federal district; will represent several sectors of the economy and can be removed by the President only "for cause". Complete dedication to the functions of the Board is required of the members. Members of the Board cannot have any position in a member bank. This limitation extends to two years.

\[63\] \textit{Id} at 34.

\[64\] 12 U.S.C. \textsection 241(1996). Congress participation in the appointing process limits in a certain way the discretion of the government, but it also produces the risk that the process will be politicized.

\[65\] Bach, \textit{supra} note 8, at 21.


\[67\] 12 U.S.C. \textsection 241(1996). (\textit{for the purposes of this note, the sectors of the economy are financial, agricultural, industrial and commercial}).

\[68\] Bach, \textit{supra} note 8, at 21.
after living the office, unless they have completed the fourteen-year term. The Board has a Chairman and a Vice Chairman appointed by the president and confirmed by the Senate for a four-year term. The chairman is the C.E.O. of the Board and presides at its meetings. In case of absence, the Chairman will be replaced by the Vice Chairman.

The Board approves the Federal Banks budget, the salaries of their officers and other expenses. The Board's staff examines the Federal Reserve Banks in order to determine their financial condition and compliance with laws and regulations.

The Board represents the system in most of its relations with the executive and legislative branches, and is the policy maker. All the issues that have contributed to the Board's independence have been discussed in different occasions by Congress and have produce tensions and different opinions.

The main functions of today's Board are to formulate the monetary policy and to supervise and regulate activities and operations of commercial banks and Federal Reserve Banks.

69 12 U.S.C. s 242 (1996). See LAWRENCE S. RITTER AND WILLIAM L. SILBER, PRINCIPLES OF MONEY BANKING AND FINANCE MARKETS, 173 (7 Ed. Basic Books Inc. 1991)[hereinafter Ritter and Silber] (Commenting that the Chairman is the most important and influential member of the Board and the FOMC, and is the “embodiment” of the central bank in the U.S).

70 Id.

71 Id.

72 Function and Purposes, supra note 7, at 21.

73 Id at 21.

74 Id at 23.

75 Bach, supra note 8, at 22.

76 See Ritter & Silber, supra note 69, at 178 (commenting that some congressmen believe that the Federal Reserve has too much independence and that other Congressmen think that some guidelines should be passed in order to limit the discretion of the system.

77 Functions and Purposes, supra note 7, at 14 (Commenting that the Board is a majority in the Federal Open Market Committee who is the most important monetary policy maker. Also stating that the Board
2.- Federal Reserve Banks

The Federal Reserve Act divided the United States territory into twelve districts, each one with a Federal Reserve Bank. The federal banks are located in Atlanta, Boston, Chicago, Cleveland, Dallas, Kansas City, Minneapolis, New York, Philadelphia, Richmond, San Francisco and Saint Louis. There are also twenty-five branches in different cities of the country. This mechanism of branches gives access to the system to different regions of the United States.

The operations of the Federal Reserve System are conducted by the Federal Reserve Banks. These banks are individual legal entities, privately owned and operating in the public interest and supervised by the Board of Governors. Earnings of these banks come mainly from loans to member banks and interest received in open market operations.

establishes the reserve requirements of the banks, regulates the discount windows of the Federal Reserve Banks and establishes the deposit interest rates. See P. Samuelson & W. Nordhausm Economics 265-325 (12th ed. 1985) (stating that the regulation of the supply of money is the most important tool policy makers).


79 Functions and Purposes, supra note 7, at 15.

80 Bernstein, supra note 22, at 847.

81 Functions and Purposes, supra note 7, at 15.

82 See section 12 U.S.C. s 282-287 which regulates the Capital and Stock of the Federal Reserve Banks. These sections establish that every national bank and member bank should subscribe stock of the Federal Reserve bank of its respective district. They also establish that no private entity different from the mentioned above can have more than U.S. $ 25,000 worth of stock of any Reserve Bank.

83 Bach, supra note 8, at 23. See also Haggot, supra note 13 at 44 (stating that Reserve Banks are between government and private but not part of the government.)

84 See also B. BECKHART, FEDERAL RESERVE SYSTEM, (1972) (establishing that the Reserve Banks are almost public entities).

85 Functions and Purposes, supra note 7, at 17.
The Federal Reserve Banks are conducted and supervised in an impartial way by a Board of Directors. The Board of directors consists of nine members divided into three categories: three class A directors which represent member banks, three class B directors which represent the public and three class C directors that represent the Board of Governors of the Federal Reserve.

In order to select Class A and B directors, member banks nominate and elect the candidates without consideration of color, sex, race or national origin. Class C directors are appointed by the Board of Governors of the Federal Reserve and cannot be stock holders of any bank. One of the class C directors is designated by the Board of Governors as Chairman of the Board of Directors of the Reserve Bank, another one is selected to be Deputy Chairman and may replace the Chairman in case of absence. Each Reserve Bank has a President selected by the Board of Directors with prior approval of the Board of Governors.

The Chairman of the Board of Directors is the federal agent that represents the Board of governors and reports to this institution. The members of the Board of Directors of each Reserve bank have a three-year term.

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87 12 U.S.C. s 302 (1996). See also Bach, supra note 8, at 25 (stating that class A director are bankers representing small, medium and large banks of the district, and that class B directors must be engaged in the commercial, agriculture or industrial sector of the district).
88 Id.
89 Functions and Purposes, supra note 7, at 17. See also Bach, supra note 8, at 25 (stating that Class B and C director cannot be officers, directors or employees of any bank).
91 Id.
3.- Federal Open Market Committee

The actual Federal Open Market Committee was created in the Banking Act of 1935 to control and determine the open market operations that will be conducted by the Federal Reserve.93 Open market operations are the most important mechanisms to make monetary policy and they include activities like buying and selling government securities, federal agencies’ securities, bankers’ acceptances, and direct operations in foreign exchange markets.94

This committee must have a national perspective of credit problems and solutions95 and makes broad policy decisions that are executed by the Federal Reserve Banks.96 These banks may engage in open market operations but only according to the directions and regulations of the committee.97

The Federal Open Market Committee is composed of seven members of the Board of Governors of the Federal Reserve and five Reserve Bank presidents98, one of them, the

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93 Functions and Purposes, supra note 7, at 14. (Commenting that the FOMC was the predecessor of another open market committee created in the Bank Act of 1933 which consist of one member from each Federal Reserve Bank. At that time, these Banks kept the faculty to decide if they participated in the operation established by the system. The Board had strong power in these topics because they regulate open market operations and they assist in the Committees meetings).

94 Id.

95 Haggot, supra note 13, at 43 (stating that this situation creates equilibrium with the regional perspective that is brought by the Reserve banks).

96 Bach, supra note 8, at 25.

97 Functions and Purposes, supra note 7, at 15. See also Bach, supra note 8 at 25.

98 See 12 U.S.C. s 263 (The representatives are elected annually in the following way: one from New York, one from Boston, Philadelphia and Richmond, one from Chicago and Cleveland, one from Atlanta, Dallas and St. Louis and one from Kansas City, Minneapolis and San Francisco.) see also Bernestein, supra note 22, at 118 (stating that even though the Board approves the candidates, it cannot control who will be selected and there is no regulation established that regulates the way in which one of these member can be remove). See Ritter & Silber, supra note 69, at 176 (commenting that in recent years not only open market operations but all policy matters are reviewed by the FOMC. Also stating that the twelve reserve bank presidents attend and participate in these meetings.)
president of the New York Federal Reserve Bank. It meets at least four times a year in Washington to review the monetary and credit situation, and after each meeting issues instructions for daily purchase and sales to the reserve Bank of New York. The committee has its own organization. The Chairman of the Board of Governors is the Chairman of the committee and the president of the New York Federal Reserve Bank is the Vice Chairman.

Detailed operations related to these matters are made by an executive committee composed of five members of the Open Market Committee, three governors and two presidents of Reserve Banks. This committee consults and makes recommendations to the Treasury on financial issues.

To some legal scholars, this committee represents a very particular example of "sharing government power with private representatives", and it's the result of political compromises between those in favor of total control by the Board, and those in favor of control by private bankers. Defenders of the actual system argued that if the Reserve Banks did not participate in this committee, their presidents will be relegated to execute routine operations and the "heart" of the Reserve System will break.

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99 Functions and Purposes, supra note 7, at 15 (commenting that the other Banks presidents serve one year and are continuously rotating).

100 Bach, supra note 8, at 25.

101 Bernstein, supra note 22, at 116.

102 Bach, supra note 8, at 25.

103 Id at 25 (Noting the deliberations of the committee necessarily have to touch different questions about credit policy).

104 Bernstein, supra note 22, at 125.

105 Id at 121 (Commenting that the House of Representatives wanted more control of the committee by the Federal Reserve, limiting the banks representatives to advisory status. Senate instead wanted a mix and share power between the Reserve Banks and the Board).

106 Haggot, supra note 13, at 43 (citing words of Allen Sproul, former President of the Federal Reserve
The conformation of the committee has raised questions about the delegation of powers and for this reason it has been challenge in courts several times\textsuperscript{107}, the last one in Melchor v. FOMC\textsuperscript{108}. In this case, a Senator of the Unites States alleged that election of members of the committee by Reserve Banks took away his constitutional role in the appointments process\textsuperscript{109}. The District Court held that Congress was authorized to delegate some of its Constitutional powers to private citizens and for this reason the composition of the committee was not unconstitutional\textsuperscript{110}. The Court also concluded that since open market operations are not inherent to government function, they can be delegated to the FOMC\textsuperscript{111}. The judgment was affirmed by the Court of Appeals\textsuperscript{112}.

All decisions rendered by the courts in these matters have made the composition of the committee judicially not revisable\textsuperscript{113}.

This committee has a great deal of responsibility in the decision making process that will affect the whole economy. The participation of private parties involves a very high risk that decisions will be adopted based on particular interests rather than on public interests. This particular situation affects the independence of the Bank in relation with private parties.

\textsuperscript{107} Bernstein, \textit{supra} note 22, at 131 (commenting that the conformation of the committee has been challenge in Brian v. FOMC, 235 F.Supp. 877 (D.Mont.1964), Reuss v. Balles, 584 F. 2d. 873 (1981), Committee of Monetary Reform v. Board of Governors of the Federal Reserve, 766 F.2d. 538 (D.C. Cir. 1985)).


\textsuperscript{109} \textit{Id} at 512.

\textsuperscript{110} \textit{Id} at 520-23.

\textsuperscript{111} \textit{Id}.

\textsuperscript{112} \textit{Id} at 510.

\textsuperscript{113} Bernstein, \textit{supra} note 22, at 131.
4.- Federal Advisory Council

This council was established to advise the Board, to guarantee adequately hearing to the member banks and to expose decisions to the public.\footnote{Haggot, supra note 13, at 38 (stating that this was a concession to the banking community since they had no representation on the Board of Governors).} It is considered a channel between the Board of Governors and the bankers.\footnote{Haggot, supra note 13, at 38.} The main function of the council is to advise the Board on business and credit conditions.\footnote{Bach, supra note 8, at 29.} The council is empowered to call for information and to make recommendations concerning the Federal Reserve System,\footnote{Bach, supra note 8, at 29.} but it has no legal power to force authorities to adopt its recommendations and suggestions.\footnote{Haggot, supra note 13, at 38.}

The council is composed of twelve members, one of each Federal Reserve District. Members are prominent private commercial bankers and are elected by the Board of Directors of the Federal Reserve Banks.\footnote{Haggot, supra note 13, at 38.} The meetings of the council take place in Washington at least four times a year. This entity selects his own officers which are the President, the Vice President, the Secretary and five executive officers.\footnote{Id at 28.}

5.- Member Banks

The banking system of the United States has a dual form; we find National and State banks. National banks are chartered by the Comptroller of the Currency and State banks are chartered by any of the states of the union.\footnote{Id.} National banks are required by law to be

\footnote{JONATHAN R. MACEY, GEOFREY P. MILLER, BANKING LAW AND REGULATION, (Little, Brown and Company 4th ed. 1992)[hereinafter Macey and Miller].}
members of the Federal Reserve System\textsuperscript{122}. On the other hand, State banks can become members of the system if they fulfill some requirements\textsuperscript{123}.

To become a member of the system, the bank must subscribe and pay for stock of the Federal Reserve bank of its district equal to six percent of its own capital and surplus\textsuperscript{124}. Once the Bank becomes a member of the system it automatically gets some privileges and some obligations.

Member banks can borrow funds from the Reserve Banks of the district subject to the regulations of the moment and they can order or forward currency according to their necessity. They participate in the election of six members of the Board of Directors of the Reserve Bank, they are allowed to use the systems facilities for different purposes like checking clearing, and they share the information provided by the system\textsuperscript{125}. Member banks are able to use a computer communication system to transfer funds and marketable government securities\textsuperscript{126}. Membership also gives prestige and publicity to the banks\textsuperscript{127}.

Membership also involves the fulfillment of certain duties. They are required to maintain the reserve requirements establish by the Board, a requirement that is usually more stringent than for non member banks\textsuperscript{128}. Members are also subject to federal laws

\begin{flushleft}
\textsuperscript{122} 12 U.S.C. s 222 (1996) (National banks are required to become members of the system when they initiate operations or within ninety days after the admission into the State were they are located).


\textsuperscript{125} Functions and Purposes, supra note 7, at 20 (commenting that checks that are not cleared by the system are cleared by local clearing houses associations, correspondents banks and directly).

\textsuperscript{126} Id at 22.

\textsuperscript{127} Bach, supra note 8, at 31.

\textsuperscript{128} Id. This situation has changed today and will be discussed in the next chapter of this work.
\end{flushleft}
and regulations regarding capital adequacy, mergers, branches, investment limitations, loan limitations and bank holding companies.\textsuperscript{129}

Banks members have a special prohibition of giving higher interests on deposits to directors, officers or employees of the system\textsuperscript{130}.

6.- Conferences and other Committees

The system organizes several conferences to deal with different policy and operative problems\textsuperscript{131}. The Conference of the Chairman’s of Reserve Banks meets in Washington at least once a year. The Conference of the Presidents of the Federal Reserve Banks and the Conference of Vice-presidents meets usually four times a year to discuss different topics\textsuperscript{132}.

They are also other committees, like the Advisory Committee on Truth in Lending which meets at the Board's request.\textsuperscript{133}

**B. Bank of the Republic**

As mention before, a new structure of the Colombian Central Bank was created in the Constitution of 1991\textsuperscript{134}. The system is composed of the Bank of the Republic, the

\textsuperscript{129} Functions and Purposes, \textit{supra} note 7, at 20.


\textsuperscript{131} Functions and Purposes, \textit{supra} note 7, at 19.

\textsuperscript{132} \textit{Id}.

\textsuperscript{133} \textit{Id}.

\textsuperscript{134} In the beginning of the 90's several Latin American countries reformed their central banks in a structural way. Examples of these reforms are Argentina, Bolivia, Chile, Colombia, Ecuador, and Salvador, Mexico, Nicaragua, Peru and Venezuela. In other Latin American countries the process is still going. Most of these reforms tend to modernize and give certain independence to the Central banks in order to avoid the misused of monetary policy for government purposes. See Daniel Duenas, \textit{Strengthening Central Bank Independence in Latin America, Recent experiences in Argentina, Chile and Venezuela}, Sixth seminar on Central Banking, 1993.
Board of Directors of the bank and the General manager of the bank. In this section I will explain in detail each of these entities.

1.- Bank of the Republic

The Constitution of 1991 broke the Montesquieu’s classic notion of the three public branches. It created special and independent organs of the state with the responsibility of fulfilling certain duties. The central bank is one example.

The bank is a public legal person with constitutional rank and with a special and unique legal regime. The Constitution granted Congress the power to passed a law that the bank has to respect while exercising its functions and that establishes the patterns that the government has to follow while issuing the statutes of the bank. Under this provision, Congress passed law 31 of 1992.

According to the constitution, the bank has patrimonial, administrative and technical autonomy. This is an express recognition of the bank’s independence.

Patrimonial autonomy means that it has his own assets in national and international currency which are managed in its own budget. The bank’s assets and profits are used

135 Colombia and Chile adopted this model which is based on the Deutsche Bundesbank of Germany. See Carlos Ossa Escobar and Jorge Enrique Ibanez Najaar, El Concepto de Autonomia de la Banca Central, LA AUTONOMIA DEL BANCO DE LA REPUBLICA (Tercer Mundo Ed., 1995)[hereinafter Ossa & Ibanez]


138 COLOM.CONT. art 372.

139 Id. One can see that the government has certain deal of power over the bank since it was granted the power to issued its statutes.

140 COLOM. CONST. art. 371.

to cover its expenses, to carry out the functions established in the Constitution and in the laws, and to create a monetary exchange fund for times of crisis.\textsuperscript{142}

By administrative autonomy, the bank is an independent and autonomous organ of the state created to be the central bank of Colombia and it is no part of the executive, legislative or judicial branches.\textsuperscript{143}

The technical autonomy means that the bank can analyze in a free way, without interference of other authorities, all the monetary, credit and exchange problems in the economy, and design the solutions required to give the confidence and firmness necessary to the system.\textsuperscript{144}

It will be contrary to democratic principles that the bank lacks any kind of control. Taking this into account, the Constitution establishes political and legal control over the bank. Every act issued as monetary, exchange or credit authority is subject to legality control by the Administrative Jurisdiction. Congress exercises political control, since the Board has to present a complete report to it.\textsuperscript{145} The Constitution empowers the President to inspect, supervise and control the bank.\textsuperscript{146} President delegated this authority to the Banking Superintendency and the Auditor of the bank.\textsuperscript{147}

The bank has its domicile and headquarters in Santafe de Bogota. D.C. and has several branches around the country created according to the needs.\textsuperscript{148}

\begin{itemize}
  \item \textsuperscript{142} \textit{Id} at 9.
  \item \textsuperscript{143} Corte Constitucional, Sentencia C-050 de Febero 10 de 1994.
  \item \textsuperscript{144} \textit{Id}.
  \item \textsuperscript{145} COLOM. CONT. art 371 inc.3.
  \item \textsuperscript{146} COLOM. CONT. art 372 inc.3.
  \item \textsuperscript{147} This supervision, inspection and control power can limit the independence of the bank. Even though, these types of control are necessary in order to avoid abuses and malpractice.
  \item \textsuperscript{148} Decree 2520 of 1993 art. 4.
\end{itemize}
2.- Board of Directors of the Bank of the Republic

The Board of Directors of the Bank of the Republic is the monetary, exchange and credit authority of the country. It is in charge of the direction and execution of all the functions concerning the bank\(^{149}\). The Board is the body that makes the policy decisions in these matters\(^{150}\).

The Board is composed by seven members which represent the public interests of the nation\(^ {151}\). Five of its members are appointed by the President for periods of four years that can be extended\(^ {152}\). Two members must be replaced each four years\(^ {153}\). this way, each President gets to replace at least two members\(^ {154}\). The Board’s term eliminates pressure by the government and guarantees that directors cannot be retired by the Government when they have different points of view. It also promotes long term decisions that maintain stability and coherence of policies adopted. Anyway, it would have been better if the Constitution gave a longer terms to the Board’s members.

The other two members of the Board are the Minister of Finance, who presides over the Board, and the General Manager of the bank\(^ {155}\). The participation of the Minister of Finance is the mechanism in which the government is represented and even though it lessens independence of the Board, it is useful because it promotes coordination in the adoption of economic policies.

\(^{149}\) COLOM. CONST. art. 372.

\(^{150}\) Corte Constitucional, Sentencia C-478 de Agosto de 1994

\(^{151}\) COLOM. CONST. art. 372.

\(^{152}\) See Law 31 of 1992 art.34 (establish that the period of each member can be extended only for three consecutive periods).

\(^{153}\) COLOM. CONST. art. 372.

\(^{154}\) See COLOM. CONST. art. 190 ( giving the President of the Republic a four year term).

\(^{155}\) Id.
These members must be exclusively dedicated to the Board.\textsuperscript{156} To be a member of the Board the law requires one to be a Colombian, a citizen exercising political rights, with a professional degree and with experience of more than ten years in subjects related to economy, finance, international commerce, banking, and economic law.\textsuperscript{157}

The Constitutional Court has made it clear that the Board is independent from the government\textsuperscript{158}. Even though this was the intention of the drafters and this principle has been recognized by the higher Court, the independence of the Board is arguable since the President is involved in the appointing process, the Minister of Finance is a member and presides over the Board and it has to act in coordination with macroeconomic policies. In practice, the Board has been totally independent of political and governmental influence.

As mentioned before, the Board also has the duty to present extensive information to the Congress relating to all the operation and policies made throughout the year. In this way, Congress exercises control over the bank.

3.- General Manager of the Bank of the Republic

The Board of Directors elects the General Manager for a four-year term which may extended for two additional periods\textsuperscript{159}.

The General Manager must be exclusively dedicated to the bank. This officer is a member of the Board of Directors and is the legal representative of the bank and has to fulfill all the duties established in the law and in the bank statutes\textsuperscript{160}.

\textsuperscript{156} COLOM. CONST. art. 372.

\textsuperscript{157} Law 31 of 1992 art. 29.

\textsuperscript{158} Corte Constitucional, Sentencia C-478 de Agosto de 1994.

\textsuperscript{159} Decree 2530 of 1993.

\textsuperscript{160} Id.
CHAPTER IV
MAIN FUNCTIONS AND PURPOSES OF THE FEDERAL RESERVE SYSTEM
AND THE BANK OF THE REPUBLIC

Central Banks have a particular role in the regulation of the economy. Even though Central Banks around the world have differences in their structure, they have some functions and purposes that are the same. These functions and purposes have slight changes in the way they are applied, but in a broad sense they are the same. One also must consider that in some countries, Central Banks lack some of these functions and that they also might have additional functions. The main purpose of the Federal Reserve System is to maintain "long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates"\textsuperscript{161}. In a very similar way the main purpose of the Bank of the Republic is to maintain the power of acquisition of the coin and the adoption of specific inflation goals that must be reduced each year\textsuperscript{162}. All the functions and purposes executed by the Bank of the Republic must be made in coordination with general economic policies.\textsuperscript{163}

In this segment the main functions and purposes of Central Banks and the way they are implemented and treated in American and Colombian systems will be discussed.

\textsuperscript{162}COLOM.CONT. art. 372. See also Law 31 of 1992, art. 2.
\textsuperscript{163}COLOM.CONT. art. 372.
A. Monetary Policy Makers

Monetary policy is part of the general economic policies a country adopts and refers basically to the measures adopted concerning money and credit conditions in a State. One of the main purpose of this policy is to create price stability in the economy. Scholars have defined monetary policy as the “action designed to influence the supply and use of money”. This narrow definition must include all means of payable instruments in order to be appropriate. A broader definition of monetary policy includes all the actions designed to control “the used of lendable funds, in the form of loans or investments, extended by commercial banks and other lending institutions”.

Central Banks are generally the monetary policy makers of the country. Several complementary mechanisms can be undertaken by the Central Bank to execute monetary policies. The most effective and used instruments are open market operations, regulation of discount operations and reserve requirements. Another important instrument used by monetary policy makers is regulation of interest rates.

1.-Open Market Operations.

Open market operations are in broad terms the purchase or selling by Central Banks of securities, commercial papers and others negotiable instruments. When the Central Bank purchases this kind of negotiable instruments, the supply of money and bank reserves are increased. When it sells, they decreased. Therefore, the purchase by the

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164 The other important economic policy that countries used is fiscal policy.

165 Haggot, supra note 13, at 484.

166 Id. This definition includes currency, loans, and investments of saving banks, insurance companies, pension funds and investment trusts.

167 Purposes and Functions, supra note 7, at 49.

168 MACROECONOMIC ADJUSTMENT: POLICY INSTRUMENTS AND ISSUES, JEFFREY M. DAVIS, (International Monetary Fund, 15 (1992).[hereinafter Davis]
Central Banks of these kinds of assets has an expanding effect, while selling has a contraction effect. The forms and regulations of open market operation vary from one country to another and their importance is directly related to development of the capital market.\(^{169}\)

The advantage of open market operations over other type of instruments is that the Central Bank has the initiative and they do not depend on commercial bank’s responses\(^ {170}\). Since the Central Bank is not engaged in a particular business activity, it can alter the selling price at its own discretion\(^ {171}\). So if it wants to lower reserves, it reduces the price of the securities and a buyer will appear. These operations are executed in different ways among the countries due to the dissimilarities between economic size and development.

In the United States, open market operations are the most popular and used instruments of monetary policy due to its flexibility\(^ {172}\) and the development of the capital market. The Federal Reserve mainly buys and sells government securities\(^ {173}\). Government securities are the most active in the U.S. financial market\(^ {174}\). Of the $2.000 billion worth of marketable government securities more than $220 billion are held by the Federal Reserve.\(^ {175}\) The government power to tax assures that the creditors will be paid and that’s

\(^{169}\)Haggot, supra note 13, at 491.

\(^{170}\)The opposite to discount operations. See Davis, supra note 165, at 15.(also commenting that OMO are flexible in time and amount, and that they can be undertaken in the primary or secondary markets).

\(^{171}\)Ritter & Silber, supra note 69, at 215.

\(^{172}\)Id.

\(^{173}\)Id.

\(^{174}\)Id.

\(^{175}\)Ritter & Silber, supra note 69, at 212. (Commenting that these securities where issued when the Treasury Department had to borrow to finance the budget deficit).
the reason why these securities are considered risk free. The Federal Reserve also deals with other instruments like Federal Agencies securities and bankers acceptances.

As mentioned before, open market operations in the United States are regulated and directed by the Federal Open Market Committee and executed by the New York Reserve Bank. This process is very complex since it has a direct effect over all the economy.

In Colombia, the Board of Directors can execute open market operations by purchasing or selling its own titles, public debt titles and any other titles further authorized. The Board determines the Intermediaries authorized for this kind of operation.

2.-Bank Reserve Requirements

Bank reserves consist of a percentage of deposits that cannot be used and must be held in cash in the bank’s vaults and in the central bank. All depository institutions are subject to reserve requirements that depend on the kind of deposit. If the Central Bank

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176 Purposes and Functions, supra note 7, at 52.

177 Id at 51. See also at 53, (Commenting that this type of instrument competes in the markets with large CD’s, commercial paper and securities issues by States).

178 See Purposes and Functions, supra note 7, at 53-8. (Commenting that the committee meets ones a month and that the manager of the System Open Market Account is responsible for day to day open market operations. Also stating that the decisions of the FOMC are taken by consensus and that information related to inflation, deflation, balance of payments, employment is examined by the Board). See also Ritter & Silber, supra note 69, at 216-17 (mentioning all the operative proceedings of an Open Market Operation). See Bach, supra note 8, at 66-67 (commenting that the FOMC has delegated much of its policy making powers in this areas to the Executive Committee, just establishing general guides and limits than the latter has to respect. Also stating that operations are execute by the Reserve Bank of New York because its the biggest bank, with the biggest and more important members and because New York is the place where most international transactions take place.)

179 See Law 31 of 1992, art.16, lit.b. See also Decree 2520 of 1993 art. 16, lit.b. (stating that from 1999, open market operations must be exclusively made through public debt titles).

180 One of the reasons for this provision is that the Colombian capital market is still developing and it will be very difficult to perform this transaction just in the stock market. The authorized Intermediaries are financial institutions like Banks, Financial Corporations, Savings and Housing Corporations, Pension Funds, and the National Treasury. See Resolution 4 of 1994 of the Board of Directors of the Bank of the Republic, art. 1, and Resolution 11 of 1995 of the Board of Directors of the Bank of the Republic, art. 5 and 9.
lowers the reserve requirement of a particular deposit, automatically the bank’s reserves are increased and they could lend more money and undertake additional transactions.\textsuperscript{181} This has an expansionist effect that produces more money circulating in the economy. On the other hand, when reserve requirements are lowered by the Central Bank, bank’s will have less money to lend and there will be less money circulating in the economy. This is a contractionist policy.

Although reserve requirements are not as flexible as open market operations, they have a rapid impact in the liquidity of the financial system and costs in the economy.\textsuperscript{182} This instrument is used to moderate inflation tendencies and to avoid recession’s tendencies.\textsuperscript{183}

The Reserve System Board of Governors is empowered by law to establish the minimum reserves that member banks must hold against demand and time deposits. The definition of deposits has been changed during the years in order to include new financial instruments and to adapt to evolution of the market.\textsuperscript{184} During the 80’s, the Banking Act and the Garn-St. Germain Depository Institutions Act established that all depository institution, including commercial banks, thrift institutions, credit unions and others, were subject to reserve requirements determined by the Board, even if they are not members of the system.\textsuperscript{185} Since this act was passed, financial institutions cannot avoid reserve requirements anymore. Membership in the system is less important if one considers that

\textsuperscript{181}Ritter & Silber, supra note 69, at 206.

\textsuperscript{182}Functions and Purposes, supra note 7, at 79.

\textsuperscript{183}Id.

\textsuperscript{184}Id.

\textsuperscript{185}Ritter & Silber, supra note 69, at 204.
reserve requirements apply equally to members and non members, and the difference between banks and thrift continues to disappear.\textsuperscript{186}

In a similar way, the Board of Director of the Bank of the Republic is entitled to establish and regulate the reserve requirements that credit institutions must maintain in the different kinds of deposits\textsuperscript{187}. These requirements are changed periodically due to diverse monetary and financial issues.

3.- Discount

Discount operations are the mechanism used by Central Banks to lend money to banks. They are also an important instrument for monetary policy and are used to provide temporary funds to banks in periods when liquidity is needed\textsuperscript{188}. Discount operations are a clear manifestation of Central Banks as lenders of last resort. Many systems used this mechanism for crises or to promote different sectors of the economy\textsuperscript{189}.

Discount operations involve the sale of an eligible paper to the Central Bank or and advance a loan sign in a promissory note secured by an adequate guarantee\textsuperscript{190}. The rates of discounts are the interests that the Central Bank charges to commercial banks for the credit. The rate of the discount and its relationship with the market’s interest is very important. If the discount rate is above the market interests, borrowing from the Central

\textsuperscript{186}Id at 206.


\textsuperscript{188}Functions and Purposes, supra note 7, at 70.

\textsuperscript{189}When a Central Bank gives credit to commercial banks with the condition to lend it to determine sectors at a special interest rate is one example of discount operations used to promote sector of the economy.

\textsuperscript{190}Functions and Purposes, supra note 7, at 70.
Bank is discouraged\textsuperscript{191}. Hence, if the discount rate is below the market interests, borrowing will be stimulated.

From the point of view of monetary effects, if the discount rate is lower, banks will borrow more from the Central Bank and this situation will produce an expansion of money and credit.\textsuperscript{192} The opposite situation will take place if the discount rate is higher.

In the Federal Reserve System, the discount rate is a privilege of member banks and is established by each Reserve Bank with approval of the Board of Governors, depending on particular regional conditions\textsuperscript{193}.

In Colombia, the Board of Directors is empowered to give authorized transitory liquidity to credit institutions by discount operations.\textsuperscript{194} Right now, the Bank has two lines of credit, ordinary and special, designed basically to provide liquidity in extraordinary situations, for example, the drop of deposits in a credit institution.\textsuperscript{195} The Board, periodically determines the rates that the bank will charge in this operations and the conditions of the credit, based on different financial and economical circumstances\textsuperscript{196}.

\textsuperscript{191}Ritter & Silber, supra note 69, at 211.

\textsuperscript{192}Functions and Purposes, supra note --, at 72. See also Ritter & Silber, supra note 69, at 211 (asserting that the discount rate might influence in a direct way the interest market by the "announcement effect"). See also Davis, supra note 165, at 16 (According to the author, discount operations must be constrained to elude alterations if OMO and the discount rate should be high enough to discourage borrowing from the central bank).


\textsuperscript{194}As in the American system, the Board can also provided liquidity byREPO's. See Law 31 of 1992 art.12, lit.c.

\textsuperscript{195}Resolution 16 of 1994, Board of Director of the Bank of the Republic, art.6-13.

\textsuperscript{196}Resolution 16 of 1994, Board of Director of the Bank of the Republic, art.3,5.
B. Ceiling Interest Rates on Deposits

This measure is used by Central Banks to control price stability and the circulation of money in the economy. In the American system, the Board of Governors sets maximum limits on interest rates that member banks can pay on time and saving deposits, among consultations with other agencies.\textsuperscript{197}

In Colombia, the Board of Directors can determine the maximum interest rates that credit establishments can pay for deposits or charge for loans. This measure can only be taken in exceptional situations and for periods that do not exceed 120 days.\textsuperscript{198}

C. International Reserve transactions, Management of International Reserves, and Exchange Policy

Central Banks have some degree of responsibility in determining exchange rates and managing reserves.\textsuperscript{199} Exchange rates are “the price of a unit of domestic currency in terms of foreign currency”\textsuperscript{200}. The exchange rate is a very important issue in the economy of a country since it affects the price of the goods traded domestically and internationally.\textsuperscript{201}

Recently, economic and legal scholars have adopted the thesis that the same entity must adopt monetary policy and exchange policy. Indeed, monetary policy affects necessary exchange policy and there is a strong link between them. This has led to the

\textsuperscript{197}The consultation of the Board is with the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board since they have similar power over the institutions subject to there jurisdiction. See Functions and Purpose, supra note 7, at 85.

\textsuperscript{198}Law 31 of 1992 art. 16, lit.e.

\textsuperscript{199}Stanley Ficher, Modern Central Banking, Bank of England, 55 (1994).

\textsuperscript{200}Davis, supra note 165, at 37.

\textsuperscript{201}Id at 35. It affects the whole price structure.
conclusion that a Central Bank cannot be totally independent if they do not have full responsibility in exchange policies.\footnote{202}

The international reserves of the United States are composed basically by gold, foreign currency and reserve position in the International Monetary Fund -SDR's-. Reserves are owned by the Department of Treasury, held by the exchange stabilization fund of the Treasury and operated by the Federal Reserve Bank of New York which has the responsibility of all the operative aspects in transactions with foreign Central Banks\footnote{203}.

The Federal Reserve engages in foreign currency operations to “cushion effect on international reserve flows of payments due to temporary forces, to smooth out abrupt changes in foreign exchange rates, and to avoid disorderly conditions in foreign exchange”.\footnote{204} The Board of Governors supervises this type of transactions.\footnote{205} Exchange policy in the U.S. is very complex because central banks around the world use the dollar in their transactions and have them as international reserves.

In Colombia, the Constitution gave the authority to the Board of Directors of the Central Bank to regulate the exchange rates in coordination with the Minister of

\footnote{202}Tomas J.T. Balino & Carlo Cotarreli, Frameworks For Monetary Stability, IMF,331(1994). For this same conclusion see also Carlo Cotarelli, The Role of Latin American Central Banks in Foreign Exchange Policy, Conferences on Latin American Central Banks, Feb.15-16, Bogota, Colombia (1996). (Concluding that specially under unrestricted movement of capitals, if exchange policy is not manage by the same decision maker, there will be conflict of interests). See also Davis, \textsuperscript{supra} note 165, at 55.

\footnote{203}Functions & Purposes, supra note 7, at 95-100.(Doing these operations, they must take into account Balance of Payments, movements in exchange rates and international financial developments. Operations with foreign central banks are called Swaps. This transactions are “inter -central banks reciprocal currency agreements” which involve two transactions simultaneously: a purchase or sale of one currency and an agreement to resell or repurchase that currency after a period of time).

\footnote{204}Function & Purposes, \textsuperscript{supra} note 7, at 100.

\footnote{205}12 U.S.C.A. s348a.(1997).
Finance. Supported on this power, the Board issued Resolution 21 of 1993 which is the exchange statute of the country.

The Bank of the Republic acts in the exchange market, purchasing or selling foreign currencies according to the Board’s recommendations. The bank is also the manager of the international reserves (Gold, SDR’s, foreign currencies, title that represent foreign currencies) and has to fulfill this function taking into account the public interest and the benefit for the national economy.

**D. Clearing House and Role in the Payment System**

The Federal Reserve provides several services to depository institutions related to the system like a network for collecting checks and other papers, a system for electronic transfer of funds and clearinghouse. These services must be provided to member and nonmember banks. The Board is the entity empowered to rule the operations of the payment system. Even though the authority of the Board in these matters was broad, in 1987 Congress passed an Act giving additional powers to the Board in these matters.

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206 See COLOM. CONT. art. 371. See also Law 31 of 1992 art.16 lit. i. See also Law 9 of 1991.

207 Law 31 of 1992 art.16 lit. i.


210 Independent Bankers Association of America v. Board of Governors of the Federal Reserve, 500 F2d 812 (1974). (The Court noted that the Board does not have to treat members and non members in a identical way, but it cannot act arbitrarily).


In Colombia, the Central Bank also provides the service of clearing house and other services related to the payment system. As in the United States, clearing houses can be created by private parties.

E. Issuing Money

The Board of Governors issues Federal Reserve Notes to make advances to Reserve Banks. These notes are an obligation of the Unites States and are legal tender for private and public debts and are the authorized currency of the union. According to this, they must be received by Reserve Banks and financial institutions, for taxes, public debts, and by the public in general.

The Constitution granted the power of issuing currency in Colombia to the Bank of the Republic in an exclusive way. The monetary unit in the country is the peso.

F. Other Functions of Central Banks

Central Banks have several kinds of functions that vary from one system to another. Other important functions that Central Banks in most countries perform, includes serving as fiscal agents of the government and lenders of last resort.

As the fiscal agent of the government, the Reserve System, among other services, receives deposits from the Treasury, has the custody of U.S. Treasury securities, holds

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214 In Colombia, Credit Institutions can participated in the creation of this particular type of enterprises. Once created, they are subject to supervision of the Banking Superintendency.
218 Law 31 of 1992 art. 6,7.
Treasury checking accounts, collects payment from buyers of securities, and pays interests for securities.\textsuperscript{220} It also operates as the banker for federal agencies.

In Colombia, the Bank also acts as fiscal agent of the government\textsuperscript{221}. Under this function the Bank may lend money to the State in special conditions\textsuperscript{222}, receive deposits, act as agent in open market operations and agent in external and internal debt contracts of the State\textsuperscript{223}.

In respect to the function of lender of last resort, Central Banks have traditionally performed this task through mechanisms like the discount window. Economist have discussed for a long time if this function is necessary, especially when the financial system is passing through problems of solvency and liquidity. For monetarists, open market operations are enough to give liquidity to the system and discount operations are not necessary\textsuperscript{224}. The Free Banking School also suggests that this function is not necessary and that the banking system must be left alone\textsuperscript{225}. For the Modern Pragmatic School, these operations are not indispensable unless there is a threat that the problems of one bank will affect other banks causing contagious bank failures\textsuperscript{226}. Regardless of these doctrines, the Federal Reserve and the Bank of the Republic act as lender of last resort through discount and advance operations in specific circumstances.


\textsuperscript{221}Law 31 of 1992, art.13.

\textsuperscript{222}Only if there is a favorable vote of all the members of the Board. See COLOM.CONT. art 373.

\textsuperscript{223}Law 31 of 1992, art.13.

\textsuperscript{224}Dirk Shoenmaker, The Lender of Last Resort and Contagious Risk in Banking, London School of Economics, 22, Feb. 1996.

\textsuperscript{225}Id at 11.

\textsuperscript{226}Id at 22.
CHAPTER V

CENTRAL BANKS AS REGULATORS AND SUPERVISORS OF THE FINANCIAL SYSTEM

A. The banking system

Due to several factors like their great levels of debt demand, their role in the creation and regulation of money supply, their susceptibility for crisis phenomenon’s, and their importance in the payment system and in the community, banks have been considered as “special”227. This “specialness” means that all over the world, banking institutions are treated in a particular and special way different from general corporations. This specialness is applicable to a certain degree to other depository institutions and to other types of financial institutions.

Banks and depository institutions are subject to limits in investments, reserve requirements, restriction on credit, capital requirements, permits to operate and other additional restrictions. There has been a strong effort by the Basle Committee on Banking Supervision to harmonize these standards around the world.

As mentioned earlier, the U.S. has a particular and unique dual banking system. This structure consists of federal and state financial institutions228. In other words, banks and thrift institutions can be chartered either by the federal government or by the state government. This determines the nature of the regulation and the regulatory agencies with jurisdiction over these entities229.


228 Id.

229 Id.
Another element which makes the American financial system unique and complex are geographic limitations. These limitations were basically established in the Mc Fadden Act passed in 1927 and in the Douglas Amendment to the Bank Holding Company Act of 1956. The Mc Fadden Act stated that National Banks and State Bank members of the Federal Reserve System can open branches in their home state if competing state banks were authorized to branch by state law. The Douglas Amendment to the Bank Holding Company Act provided that Bank Holding Companies located in one state were allowed to acquire banks in other states only if it was expressly authorized by the law of the state. These provisions gave the power to determine branch banking and expansion to state legislators. These geographic limitations have affected in a direct way the competitiveness of the banking industry.

The U.S. financial system is composed of several institutions like National Banks, State Member Banks, State Nonmember Banks, non insured State Banks, Federal and State Insured Saving Associations, non insured State Savings Associations, Federal and State Credit Unions, Bank Holding Companies, Saving Association Holding Companies, Edge Corporations, Branches of foreign banks and U.S. branches of foreign banks. One has to bear in mind that other types of financial institutions exist, like trust institutions, and that business like insurance and securities has a very strong link with the financial sector.


231 12 U.S.C s 36 (c), 321 (1997).


233 Wilmarth, supra note 230, at 962.

This particular structure of the American financial system has historical reasons and is a product of Congressional reactions to different economic circumstances. Today, more than 12,000 commercial banks exist in the U.S.\textsuperscript{235} and thousands of other kinds of financial institutions.

Recent technological advances, specially in the computers and communications fields, have lead to nationalization and globalization of the system\textsuperscript{236}. All of these factors have reflected in a movement toward consolidation of the financial system\textsuperscript{237} which apart from the traditionally decentralized banking structure\textsuperscript{238}. This process is taking place in states that have limited restrictions\textsuperscript{239} mainly through subsidiaries of bank holding companies, new branches of financial institutions and interstate credit card services.\textsuperscript{240}

Defenders of banking expansion argued that this process will benefit consumers, generate economies of scale, produce less risk of bank failure, promote competitiveness and improve the quality of services. Detractors of banking expansion suggest that it will produced undue concentration of resources, reduced competition, raised prices and affected rural areas\textsuperscript{241}.

Since the process of expansion and consolidation was started in the United States, the American system is getting more similarities with other systems like the Japanese and the


\textsuperscript{236}Id.

\textsuperscript{237}Macey and Miller, *supra* note 121, at 387.

\textsuperscript{238}Wilmarth, *supra* note 230, at 959. *see also* at 961 (stating that decentralized banking is based on the theory that concentrated financial power will lead to monopoly practices).

\textsuperscript{239}Id at 963 (commenting that since 1980 every State permits limited branching in its borders, than more than 40 States allowed statewide branching and that most States have passed laws allowing interstate acquisition of banks by Bank Holding companies).

\textsuperscript{240}Macey and Miller, *supra* note 121, at 387.

\textsuperscript{241}Id at 388.
European. But even though the process of consolidation is taking place, there are still several limitations at state and federal level.

The traditional role, activities and definition of a Bank have changed in present times. Savings institutions, financial companies, and other types of financial institutions are offering products that were before forbidden to them. In the same way, banks are offering services and products that were not permitted for them in the past, for example, brokerage services and credit cards.

Several laws have been passed that also change in a substantial way the structure of the financial system. The Monetary Control Act and the Garn-St Germain Act of 1982, statutes passed by the Congress during the 90's, authorized thrift institutions to offer NOW accounts which are very similar to checking accounts. They also permitted these institutions to provide money market accounts, overdraft loans, non residential estate lending and other forms of commercial lending. In 1987 another act related to thrift institutions was passed. This was the Competitive Equality Banking Act which permitted Thrift Holding Companies to engage in almost the same activities as Bank Holding Companies. These acts reduced even more the distinctions between saving and commercial banks.

242 According to the doctrine, the U.S. model is known as the American Bank Holding Company. The German and European Community have the universal banking model in which any entity that engages in a banking activity is considered a bank. In the Japanese model, there is a separation of investment and commercial banking, and restrictions over common ownership of banks and insurance companies. See Macey and Miller, supra note 121, at 744.

243 The Line Of Commerce For Commercial Bank Mergers: A Product Oriented Redefinition, 96 Harv.L.Rev.907, 915 (1893) [hereinafter Harvard].

244 Id at 914.


246 Macey and Miller, supra note 121, at 468.

247 Id at 468. (citing 12 U.S.C. s1730a(c)(2). (also stating that this act permits multiple Savings and Loan
A very important act passed recently, is the Financial Institutions Reform, Recovery and Enforcement Act of 1989. This act amends parts of the Bank Holding Companies Act, permitting Bank Holding Companies to acquire savings and loan associations.\(^{249}\) In this way, holding companies are able to operate banking and savings institutions.\(^{250}\)

Another issue to consider in the American banking system is that mergers and acquisitions are one of the most important forms of expansion in the banking system. These mechanisms have gained a lot of popularity in the past years and are constantly being used by Bank Holding Companies and banking entities in the process toward consolidation of the system.\(^{251}\)

In 1994, Congress passed the Riegle Neal Interstate Banking and Branching Efficiency Act. This act modifies the Douglas Amendment Act in the sense that it authorizes Bank Holding Companies to acquire banks regardless of state law\(^{252}\). It also authorizes mergers of banking institutions from June 1997 without consideration of state law\(^{253}\). Now states can only restrict mergers and acquisitions of Banks and Bank Holding Companies in limited circumstances\(^{254}\).

Colombia has a less complicated financial system especially if one takes into account that there is not any type of branching restrictions and that there is not a dual banking

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\(^{249}\)Macey and Miller, *supra* note 121, at 326.

\(^{250}\)Id.

\(^{251}\)Wilmarth, *supra* note 230, at 961.


\(^{253}\)Riegle-Neal, §102.

Before 1990 the Colombian financial system had the specialized banking model. The system was composed of several financial institutions with specific and limited functions and purposes. Each financial institution was authorized to provide certain kinds of financial services or products. During the past seventy years, different kinds of institutions were created. When a new financial instrument was created in the national and international markets or every time there was a need to develop a specific sector of the economy, a new type of financial institution was founded. Institutions like commercial banks, mortgage banks, financial corporations, leasing and factoring companies, and many more existed. Each of these had their own objectives, goals and target markets.

This legal and economical structure became obsolete. The financial system was not efficient and competitive, and had very high operative and administrative costs. Besides, big financial groups began to appear, raising additional problems like lack of control and supervision as a group, attempted by these groups to control other sectors of the economy and increase in the oligopolic structure of the system. This situation with other factors produced a financial crisis in 1992.

Due to these reasons and that Colombia decided to become an open market economy, the necessity for a deep financial reform was perceived. Many discussions of the banking model that should be adopted emerged. Some held that the specialized banking model should be maintained. Others were in favor of the adoption of the Universal banking model in which one institution is authorized to offer all kinds of financial products and services.

255 The model of specialized banking is criticized because it is inefficient, raises prices of credit, produces high costs, promotes small companies that are unable to undertake big financial projects and makes more difficult the adoption of monetary policy. Its advantages are that it makes the system more competitive and the influence of financial institutions over the economy is less.

256 The Universal Banking model or Multibank is characterized because it reduces operative and administrative costs of financial institutions, decreases the cost of credit and provides for a more efficient
In 1990, after revising the government project, Congress decided to adopt an intermediate banking model known as Filial’s and Subsidiaries, similar to the American Bank Holding Company model. The advantage of this model was that it eliminated the dangers of the other models but it took advantage of its benefits. In fact, this model produces economies of scale but avoids conflicts of interests and reduces risks of contagious bank failure among parent and subsidiaries’ companies.

According to law 45 of 1990, Banks, Financial Corporations and Commercial Finance Companies can participate in the capital of trust companies, stock commisionists, leasing companies, pension funds management companies and general deposit stores. Saving and Housing companies were permitted to invest in trust companies and pension funds management companies.\textsuperscript{257} In other words, credit establishments were allowed to participate in the capital of financial services companies.

Under this structure, each entity has his own capital, administration and accounting, and filial’s and subsidiaries are not allowed to participate in the capital of the parent company.

This law also gave total liberty for foreign investors to invest in financial institutions without any limitation.\textsuperscript{258}

In 1993 the government, empowered by law 35, issued a decree adopting the statute of the financial system which unified all existing financial legislation.\textsuperscript{259} According to the statute, the Colombian financial system is composed of credit institutions, financial

\begin{footnotesize}
\textsuperscript{257}See Law 45 of 1990.

\textsuperscript{258}Law 45 of 1990, art. 28.

\textsuperscript{259}See Decree 663 of 1993.
\end{footnotesize}
service companies and capitalization societies.\textsuperscript{260} Banks, financial corporations, housing and savings companies and commercial finance companies are considered credit establishments.\textsuperscript{261} On the other hand, trust companies, general deposit stores and pension funds management companies are considered as financial service companies.\textsuperscript{262}

This statute settles all the operations and activities that each entity can undertake. The innovation introduced by the statute was that different types of financial entities were empowered to participate in several operations and services that were restricted in the past. In this way, the model adopted in the financial reform was faded, moving discreetly toward a universal banking structure with the only difference being that several types of institutions, and not just one, can provide almost the same financial services and products.

Today, the Colombian system is developing in an important way. The institutions owned by the government are being privatize, many foreign investors are acquiring existing banks or are creating new financial institutions. Technology, globalization and competitiveness have improved and costs will decrease eventually. The main problem still remaining is the high rates of market concentration and the oligopolic structure of the system.

**B. Regulation and Supervision**

The most common regulator of economic issues in democratic countries is the Congress. Generally, this power is granted by the Constitution. Congress establishes the general parameters that must be adopted and determines the agencies with the power to intervene for a more detail regulation for the day to day operations. The financial system is a very active sector which changes rapidly. Laws are made to last long and cannot be

\textsuperscript{260}Id art.1.

\textsuperscript{261}Id art.2.

\textsuperscript{262}Id art.3.
changed every time there is a variation or innovation in the system. All of the above reasons justify the existence of specific regulators in order to have a more effective and efficient system. Indeed, these regulators have to respect the general parameters established in the Constitution and in the laws that empowered them. Baring this in mind and for the purposes of the financial system, regulation can be defined as the formulation, by authorized agencies, of specific rules for the conduct of banking.\textsuperscript{263} These rules must promote healthy practices for the correct practice of the business of banking.

The safety and soundness of depository institutions and other financial companies is very important for the economy and monetary stability for reasons already mentioned in this work. In order for banking regulations to fulfill their purpose and to avoid future problems, the responsibility of supervising the achievement of these rules must be granted to someone. In this context, one can define Supervision as an activity with the basic purpose of determining if banks, other depository institutions, and financial institutions are operating in accordance with the law and regulations. Supervision is essential to provide the system with security, transparency, confidence and to avoid abuses, crisis and panics. It will not make any practical sense if regulations existed and there was not a supervisor to enforce them. Besides, supervision is needed for confidence and security of investors and the general public.

The American regulatory and supervisory system over the financial system is very complex. It is composed of several agencies empowered by Congress in various laws, with different jurisdiction and sometimes with overlapping authority. The most representative federal agencies in these fields are the Federal Reserve, the Comptroller of the Currency, the Federal Deposit Insurance Corporation (FDIC) and the Office of Thrift Supervision.

\textsuperscript{263}Functions and Purposes, \textit{supra} note 7, at 108.
The Office of the Comptroller of the Currency is part of the Department of Treasury and is empowered to charter national banks and has the duty to regulate and supervise them.\textsuperscript{264}

The Federal Deposit Insurance Corporation is an independent agency directed by a board composed of the Comptroller of the Currency, the Director of the Office of Thrift Supervision and three members appointed by the President for a six-year term. This agency provides deposit insurance to national banks, state banks, and some thrift institutions. It also supervises institutions with deposit insurance, handles bank failures and manages the insurance funds.\textsuperscript{265} Insured institutions have to pay a premium to the FDIC over their deposits. Since 1980, the insurance coverage over deposits increased to $100,000 dollars.\textsuperscript{266} This entity is very important considering that federally chartered institutions and states members are required to have federal insurance while state nonmember institutions have this possibility.

The Office of Thrift Supervision was created by the Financial Institutions Reform, Recovery and Enforcement Act of 1989. Among other functions, this agency is in charge of regulating and supervising insured and state chartered Saving and Loan Institutions and Savings and Loan Holding Companies.\textsuperscript{267}


\textsuperscript{265}Macey and Miller, supra note 121, at 61 .See 12 U.S.C 1817(b)(1)(a) (the system is risk based in which each financial institution is classified according to several factors. Principal regulator of non-members state banks).

\textsuperscript{266}Muckenfuss, supra note 264, at 3. The definition of deposit is very important and has been subject of several litigation. Today, the FDIC regulates and controls over 975 institutions. The insurance system is criticized because it produces a bad incentive for banks and increases the cost for the public. See Macey and Miller, supra note 121, at 253. The effectiveness of the FDIC is also a question because of bank failures occurred during 1989 and 1991.

\textsuperscript{267}Macey and Miller, supra note 121, at 61.
They are some fifty-one State regulators and supervisors, and other institutions with regulatory and supervisory powers operating in different jurisdictions, like the National Credit Union Administration and the Resolution Trust Corporation.\textsuperscript{268}

In Colombia, the 1991 Constitution provided a dual form of regulation. The intervention of the financial sector is performed by Congress through a general law that determines the limits, reaches and purposes that have to be followed by the government\textsuperscript{269}. This provision finished a discussion that took place for a long period of time between scholars and the courts in relationship with the power of each state branch. The president can intervene in the system but always in accordance with the law passed by Congress. Another form of regulating the system is the one exercised by the Central Bank that will be discussed further in this work.

Under the constitutional attribution. Congress issue Law 35 of 1993 which established the general parameters, objectives, purposes and criteria that must be observed by the government while regulating the financial system. This law empowered the Ministry of Finance to regulate, through the Technical Vice Ministry, several issues of the system, for example the types of operations that each entity can undertake, regulation concerning capital adequacy and terms of operations.\textsuperscript{270} Powers granted to the Government have their limits because they cannot alter the structure of the system. In practice, the broadness and generality of Law 35, means that the system is regulated by the President through the Technical Vice Ministry of Finance.

\textsuperscript{268} Id at 62.

\textsuperscript{269} COLOM. CONST. art. 150, num. 11, art. 150, num. 21, art. 150, num. 19, art. 120.

\textsuperscript{270} Law 35 of 1993, art. 34.
Supervision is a constitutional responsibility of the President which exercises this power in accordance with the law. Supervision is done over the activities and over the persons involved in financial activities.\(^{271}\)

The President delegated this faculty to the Banking Superintendency, which is a technical organism, enclosed in the Ministry of Finance. This Superintendency was created in the earlier 20's and has been organized through numerous government decrees. Its main purpose is to control, inspect and supervise all financial institutions, insurance companies and the Bank of the Republic.\(^{272}\)

The deposit insurance is provided by the Fund of Guarantees of Financial Institutions -FOGAFIN- which deals with institutions having solvency problems\(^{273}\). This entity does not have the powers and prerogatives that the FDIC has in the U.S.

C. Federal Reserve System

The Federal Reserve System is one on the main regulators and supervisors of the American banking system. For the purposes of this work, we will focus on its power over banks, bank mergers, bank holding companies, international banking and other ways of intervening in the system.

1.- Supervisory Powers over banks

The Federal Reserve has the responsibility to supervise state member banks. Among other things, it approves their admission to the system, supervises their activities and enforces regulations\(^{274}\). It also regulates technical matters of their operation. Some of this authority is delegated to the Federal Reserve Banks.

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\(^{271}\)See Law 35 of 1993, art.10.

\(^{272}\)Decree 1284 of 1994, art.2

\(^{273}\)See Law 117 of 1985.

These regulatory and supervisory functions are shared with state governments agencies, a situation that sometimes produces overlapping responsibilities. As mention already, national banks are regulated and supervised by the Office of the Comptroller of the Currency, which informs the Board of Governors of the Federal Reserve about of operation of this kind of banks.275

2. - Mergers

One way of expansion of the banking system that is being used frequently by banks and bank Holding Companies are mergers.276 These transactions sometimes raise concerns because they have the ability to produce anticompetitive effects. Mergers and acquisitions can be either horizontal or market extension. The concept of horizontal refers to mergers or acquisitions of institutions who were in direct competition within a given market before the transaction took place.277 Market extension transactions are those mergers or acquisitions between banks who were in a different market and did not compete in a direct way prior to the transaction.278

The Bank Merger Act deals with merger transactions and other forms of combination of depository institutions like acquisitions.279 The act expressly establishes that an insured depository institution should obtain prior written approval of the responsible agency if it has the intention to merge with another insured280 or non insured depository

275 Id.

276 See Wilmarth, supra note 230, at 961.(commenting that this process has taken place specially during the 80's and 90's).


278 Id.


institution\textsuperscript{281}. This approval is also necessary if an insured depository institution is trying to acquire assets or assume liabilities of other insured\textsuperscript{282} or non insured depository institutions.\textsuperscript{283}

If the resulting, acquired or assuming institution is a state member bank, the responsible agency will be the Board of Governors of the Federal Reserve System.\textsuperscript{284} The Comptroller of the Currency has authority to approve these kinds of transactions if the surviving institution is a national bank and the FDIC if it is a State nonmember bank.\textsuperscript{285} This is a clear manifestation of the Reserve System as Regulator and Supervisor.

To obtain Boards approval, there is a special procedure that the merging companies have to follow.\textsuperscript{286} Before the Board approves the transaction, the proposal must be published with intervals in a form authorized by the agency and in a newspaper of general circulation in the headquarters where the institutions are located.\textsuperscript{287}

Management, financial and future projections of the resulting institution are considered by the Board to grant approval\textsuperscript{288}. The Board of Governors, as the responsible agency, has the duty to request reports in competitive factors involving the transaction to the Department of Justice and should not approve if it finds that the transaction will result in a monopoly of the business of banking, resulting in a combination or conspiracy


\textsuperscript{282}Id.


\textsuperscript{284}12 U.S.C. s 1828 (c)(2)(b)(1997). See also subsection (c) and (d) which gives authority to the Corporation if the resulting entity is a state non member insured bank and to the director of Thrift Supervision if the institution is to be a saving association.


\textsuperscript{286}See 12 U.S.C. s 1828.

\textsuperscript{287}See 12 U.S.C. s 1828 (c).

\textsuperscript{288}Functions and Purposes, supra note 7, at 116.
to monopolize, an attempt to monopolize or its effects are to lessen competition or restraint of trade. The principles of these provisions are taken basically from the Sherman Act and the Clayton Act.

The parameters for analyzing anticompetitive effects in merger transactions of banking institutions are the same as general antitrust laws. The first thing to do when analyzing a case in which a merger is involved, is to define the relevant market. In order to do so, first a definition of the relevant line of commerce or product market is required. Afterwards, the Board has to define the geographic market. The next step is to determine the anticompetitive effects of the merger or acquisition in the product and geographic markets determined.

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290 Macey and Miller, supra note 121, at 444.

291 Mahoney, supra note 245, at 308.

292 The definition of product markets in mergers of banks is based on what the court has called the “cluster approach”. This concept refers to the cluster of services and products denoted by the term “commercial banking”. This principle was adopted by the Court in U.S. v. Philadelphia National Bank 374 U.S. 321 (1963) and emphasized in United States v. Phillipsburg National Bank & Trust Co. 399 U.S. 350 (1970). In U.S. v. Connecticut National Bank, 418 U.S. 656 (1974) the inclusion of saving institutions in the product market was expressly rejected by the Court, but the possibility that in future cases, when the developing of the financial system is in such stage that there is no need to distinguished from commercial banks, was let open. Recently, in United States v. Central State Bank, 817 F2d 22 (1987) the Court reaffirmed the “cluster approach”. This approach has been criticized because the financial system is very different now. Consumers have today the option of choosing between banking and non banking institution to satisfy their credit requirements. Changes and developments have made possible for thrift institutions to provide almost the same products and services as banks. See The Line Of Commerce for Commercial Bank Mergers: A Product Oriented Redefinition, 96 Hard. L. Rev. 907,915 (1983). This new thesis has not been accepted yet by the courts.

293 See Philadelphia National Bank. 374 U.S. 321, 356(1963). The definition of the geographic market will determine if the merger or acquisition will be horizontal or market extension. In Philadelphia National Bank the court stated that in determining the geographic market one must look not at where the merging parties do business or where do they compete but to the “area of competitive overlap” where the effect of the merger on competition will be direct and immediate. This narrow approach was maintained in Connecticut National Bank 399 U.S. 350 (1970). For some legal scholars, changes in the banking system have made this approach obsolete. Any change in these definitions will have a strong repercussion in future bank merger cases.

294 Id at 309. Traditionally, the determination of the market share was measure by the shares held by the biggest firms in the market. This method has been replaced by “Herfindahl-Hirshman Index” contains
Despite this conventional analysis, the statute authorized the Board to allow the transaction in the name of the public interest if it finds that it will serve the convenience and needs of the community. This exception called by the doctrine the “public interest defense” makes possible mergers or acquisitions that in other contexts will violate directly the antitrust laws and will not be permitted.

The Bank Merger Act introduces a new mechanism to challenge merger transactions for antitrust reasons. In fact, the Act expressly states the term in which the transaction can be challenged for antitrust purposes. This action should be commenced after the approval of the transaction and before its consummation.

Once the merger is consummated and any antitrust litigation commenced before the consummation is terminated, it can never be attacked again for violating antitrust laws. In other words, the merger will be immune from antitrust challenge by the Department of Justice and private parties.

the Department of Justice guidelines concerning horizontal mergers and acquisitions. The main objective of the guidelines is to generate predictability of the enforcement of antitrust laws by the Federal Trade Commission and the Department of Justice. The guidelines established the parameters that the agencies will apply to horizontal mergers in order to determine if they substantially lessen competition. Even though the guidelines are not always consistent with case law, they do not necessarily reflect the state of the law, and are not binding to the Courts, they are a good parameter for antitrust scrutiny. See U.S. Department of Justice and Federal Trade Commission 1992 Horizontal Merger Guidelines, 57 Fed. Reg. 41,552 (1992). See also ELEANOR M. FOX & LAWRENCE A. SULLIVAN, CASES AND MATERIAL ON ANTITRUST, 750 (West Publishing Co., 1989) See also Joshua F. Greenberg &Atan Arbisser, The Antitrust Aspects of Mergers, 634 PLI/Corp 71, (citing FTC v. PPG Industries, Inc., 780 F2d 1550,1503-4 (D.C. Circuit 1986) and Lerinlaw Acquisition Corp. v. Mayflower Group, Inc., 636 F.Supp. 1513, 1521 (S.D. Ind. 1986))

Id.

Id at 445.

12 U.S.C. s 1828 (c)(7)(a) (1997). The lapse of time required to consummate the merger or acquisition depends on the comments made by the Attorney General related to competitive factors but it can never be less than fifteen days calendar after approval.


Macey and Miller, supra note 121, at 445. See also Gorinson, supra note 30, at 424, (stating that the Antitrust Division has 30 days after approval to challenge under antitrust laws. Also that now there is more cooperation between this division and the Office of the Comptroller and there is a possibility to “fix-it-first”
Of course this provision does not mean that in the future the resulting financial institution is exempt from the fulfillment of antitrust laws.\textsuperscript{300} Additionally to agency scrutiny, during the terms established by the Act, this type of transaction can be challenged by the Department of Justice if it concludes that there is a violation of the Sherman Act or the Clayton Act.\textsuperscript{301}

The Riegle Neal Interstate Banking and Branching Efficiency Act passed in 1994, provided that in case of mergers of State member banks there is an express prohibition for banks which hold at least 10% of the deposits of insured institutions in the U.S. to merge with another depository institution. The Board must also consider this point. This restriction is also extensive to banking institution and its affiliates if they control 30% or more of the insured deposits. Each state is empowered to modify this percentage.\textsuperscript{302}

3.-Bank Holding Companies

The Regulation of Bank Holding Companies is based on the perception that they must be constrained due to their size and influence in the economy,\textsuperscript{303} and to avoid

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\textsuperscript{300} 12 U.S.C. s 1828 (c)(7)(c)(1997). However several differences exist between special banking laws and general antitrust laws. For example, depository institutions need to get prior approval of the transaction by the responsible agencies while non depository institutions do not required prior approval. Transactions that under general antitrust laws are anticompetitive can be allowed in the financial system if they benefit the public interest in general antitrust laws, there is not an explicit exception like this. Banking regulations also defers from general antitrust laws because they impose a “30-day stay” of the transaction after it is approved by the responsible agency. Passed these term without being challenged, the merger or acquisition is immune from antitrust challenged. See Macey and Miller, supra note 121, at 444.

\textsuperscript{301} Mahoney, supra note 245, at 313. Even though special laws exist, general antitrust law is still applicable. The Supreme Court has expressly treated the issue of application of the Sherman Act and the Clayton Act to bank mergers. See United States v. Philadelphia National Bank, 374, U.S. 321 (1963). See also United States v. First National Bank of Lexixton, 376 U.S. 665 (1964). The Court has emphasized that legislative history of the Bank Merger Act and the Bank Holding Company Act reflects that Congress did not intend to displace the enforceability of the Sherman Act and section 7 of the Clayton Act, and therefore they are still applicable.


\textsuperscript{303} Macey and Miller, supra note 121, at 293.
monopolies and restraint of trade.\textsuperscript{304} Another purpose of this Act was to emphasize the separation between banking and commercial activities. The Bank Holding Company Act was passed in 1956 by Congress and it was amended in 1970.\textsuperscript{305} Legislative history of the Bank Holding Company Act reflects the desire of legislators to prevent the concentration of the financial system and to implement a policy against control of singles entities of banking and non banking organizations.\textsuperscript{306} Another important issue for the enactment of the BHCA, was that it will serve as source of strength to the subsidiaries.\textsuperscript{307}

A Bank Holding Company is a company that controls a bank or another company which controls a bank.\textsuperscript{308} The definition of “bank” and the term "control" are very important in order to determine if an entity can be considered a bank holding company.\textsuperscript{309} Prior to the Competitive Equality Act of 1987 “banks” were defined in a very simple and narrow way. After this Act, and for purposes of the Bank Holding Company Act, banks were defined as insured institutions that accept demand deposits and are engaged in the business of making commercial loans\textsuperscript{310}. Non insured institutions by the FDIC can also be considered banks if they offer “check like” deposit accounts\textsuperscript{311}. A bank holding

\textsuperscript{304} Purposes and Functions, \textit{supra} note 7, at 110.

\textsuperscript{305} \textit{Id.}


\textsuperscript{307} Macey and Miller, \textit{supra} note 121, at 302.


\textsuperscript{309} Macey and Miller, \textit{supra} note 121, at 296.

\textsuperscript{310} 12 U.S.C. s 1841(c)(1)(1997).

\textsuperscript{311} Macey, \textit{supra} note 11, at 301.
company controls a bank when it has 25% or more of the voting shares, has a strong influence in its management or controls the election of the directors.\textsuperscript{312}

A company that becomes a Bank Holding Company has to register with the Board of Governors which is empowered to regulate all the issues related to it\textsuperscript{313}. The Board also has the faculty to examine that its regulations have been adopted by the Bank Holding Companies or the subsidiaries\textsuperscript{314}. These are clear examples of the Central Bank as regulator and supervisor of the system.

This Act granted authority to the Board of Governors of the Federal Reserve to approve transactions of Bank Holding Companies in banking institutions and in companies with business closely related to banking.\textsuperscript{315}

In relation with banking transactions, any acquisition of more than 5\% of the voting shares of a bank, or of all the assets of a bank, and any acquisition that produces that the company will become a Bank Holding Company or a subsidiary of a bank Holding Company, requires prior approval by the Board of Governors.\textsuperscript{316}

In order to approve or deny these kinds of acquisitions, the Board considers several issues. One of the main factors the Board considers when reviewing a Bank Holding Company activity is the competitive factor. The statute expressly establishes that the Board should not authorize any acquisition, merger or consolidation of a Holding Company that produces that the company will become a Bank Holding Company or a subsidiary of a bank Holding Company, requires prior approval by the Board of Governors.\textsuperscript{316}

\textsuperscript{312}12 U.S. C. s 1841(a)(3)(1997). The Board has great discretion in determining when control exists. There is a presumption that a company that owns or control less than 5\%, does not have control for the purposes of the BHCA. See Macey and Miller, supra note 121, at 371.


\textsuperscript{315}12 U.S.C. s1842 and s1843 (1997).

\textsuperscript{316}12 U.S.C. s1842(a) (1997). After the application is received, the Board notifies the Comptroller of the Currency or the supervisory agency for comments. Afterward, the Board issues an order denying or approving the application. See also 1842 s1842 (b).
Company that will result in a monopoly, a combination or conspiracy to monopolize, an attempted to monopolize or that substantially lessens competition, or restraints trade of the business of banking in the United States.\textsuperscript{317} These antitrust principles are borrowed from the Sherman Act and Section 7 of the Clayton Act\textsuperscript{318}.

The Board uses the traditional antitrust analysis, defining the product market, the geographic market and the market share in order to determine if the transaction will have an adverse effect on competition.\textsuperscript{319} Like in the Bank Merger Act, the merger or acquisition can be approved even if it has anticompetitive effects, if the Board finds that the transaction will benefit the public interest because it meets the “convenience and needs of the community to be served”.\textsuperscript{320} Before it grants or denies approval of the acquisition, the Board must also take into account financial and managerial resource factors, and community benefits.\textsuperscript{321}

This statute also forbids Bank Holding Companies from engaging in business not related to banking,\textsuperscript{322} but this provision is flexible if one considers that Congress established several exceptions to this provision.


\textsuperscript{318}A.L.R., supr note 306, at 438.

\textsuperscript{319}The Board of Governors position defining the product market has been to use the “cluster approach” when it has to approve acquisitions by Bank Holding Companies. The Board also uses the HHI to measure the concentration of the market. See Irving Bank Corporation v. Board of Governors of the Federal Reserve System, 845 F2d.1035,1039 (1988). (Case that involved a horizontal acquisition and merger of two bank holding companies. These acquisitions were approved unanimously by the New York State Banking Board and by Board of Governors of the Federal Reserve which found that it will not have a perverse effect on competition. The Board used the “cluster approach” to determine the product market establishing that it was the “commercial banking business”. In determining the geographic market, the Board also used traditional standards. The Court decision emphasized the principle that “findings of the Board as to the facts, if supported by substantial evidence, shall be conclusive”.


\textsuperscript{321}12 U.S.C. s 1842(c)(2)4. The Board looks at convenience for the community to be served, and financial and managerial elements like experience and integrity of directors and officers.

\textsuperscript{322}12 U.S.C. s 1843(c)(1997).
One of the main exceptions refers to the possibility of Bank Holding Companies to engage in activities that the Board has determined “closely related to banking or managing or controlling banks as to be a proper incident thereto”\(^\text{323}\). The Board has tremendous power to decide if a business activity is related or not to banking. Under this provision, the Board issued Regulation Y which established activities that are considered closely related to banking. According to this, Regulation activities like trust services, financial advisory, leasing of real property, underwriting of credit life insurance and securities brokerage services are considered related to banking and hence are permitted for Bank Holding Companies. \(^\text{324}\) This exception has been subject to multiple decisions by the courts and has extended the reach of these entities to different kinds of business.

Before a Bank Holding Company acquires or engages in a nonbanking activity, it should seek for a decision of the Board considering the activity closely related to banking. \(^\text{325}\) If a Bank Holding Company desires to acquire 5% or more of the shares of a company that is under these exceptions, it needs prior approval of the Board. In its analysis the Board also considers competitive and public benefit factors \(^\text{326}\).

With the objective of controlling the power of these institutions, the Riegle Neal Interstate Banking and Branching Efficiency Act of 1994 introduced a rule that consists in forbidding Bank Holding Companies with 10% or more of the total deposits of insured institutions to acquire other institutions \(^\text{327}\). In this way the size and influence of these institutions is controlled. This restriction applies to Bank Holding Companies which

\(^{323}\text{12 U.S.C. s 1843(c)(8)(1997).}\)

\(^{324}\text{Miller and Macey, supra note 121, at 302-3.}\)

\(^{325}\text{Id.}\)

\(^{326}\text{Functions and Purposes, supra note 7, at 114.}\)

\(^{327}\text{Riegle-Neal s 101.}\)
have more than 30% of the total deposits of insured institutions in a particular State\textsuperscript{328}. Each State is empowered to modify this percentage\textsuperscript{329}. In making its decision, the Board must bear in mind these new provisions.

4.- International Banking

International banking can have two main different forms; International activities of American banks and foreign banks engage in business in the U.S.

The International activities of U.S. banks are regulated mainly by the Board of Governors. These activities can adopt different forms, like branches, agencies or representative offices abroad, Edge Corporations, Export Trade Companies, subsidiaries, foreign investment and International Banking Facilities.

Member banks of the Federal Reserve System are allowed to open branches in a foreign country\textsuperscript{330}. This mechanism needs approval by the host country and by the Board of Governors but only for the first two countries where it has established a branch.\textsuperscript{331}

Edge Corporations are federally chartered institutions engaged in international business and regulated by the Federal Reserve.\textsuperscript{332} They do not have restrictions on interstate banking and are free from most reserve requirements.\textsuperscript{333} There are two kinds, of edge corporations, investment edges which do not take deposits and basically invest on

\textsuperscript{328}Id.

\textsuperscript{329}Id.

\textsuperscript{330}Macey and Miller, \textit{supra} note 121, at 708. Also commenting that the FDIC regulates these activities for non member banks.

\textsuperscript{331}P. Nicholas Kourides, \textit{United States Bank Regulation of International Banking Activities}, 509 PLI/Comm 301, 30891989)[herinafter Kourides].

\textsuperscript{332}Id at 312.

\textsuperscript{333}Macey and Miller, \textit{supra} note 121, at 70.
foreign firms, and banking edges which perform the traditional banking services like deposit taking.\textsuperscript{334}

Exporting Trading Companies were created in 1982 to promote credit to medium and small exporters.\textsuperscript{335} They are subject to regulations by the Reserve Board. Bank Holding Companies and Edge Corporations can invest up to 5% of their capital and surplus in these companies.\textsuperscript{336} These transactions can be disapproved by the Board to prevent concentration, an adverse effect on the Bank Holding Company and for lack of information provided.\textsuperscript{337}

In accordance with the International Banking Act of 1978, the Board authorized U.S. banks to have international banking facilities. The purpose of this measure was to bring back to the United States off shore business.\textsuperscript{338} International banking facilities are regulated by the Board of Governors but application and approval is not necessary.\textsuperscript{339} The advantage of these entities is that they avoid reserve requirements and state taxes, but they keep the same privileges of any banking organization in the U.S.\textsuperscript{340}

Another mechanism for participating in international markets is by investing. Foreign investment by banks and Bank Holding Companies is subject to the Board's Regulation K. These operations must be reported to the Board. A bank can also operate through

\textsuperscript{334}Id. American banks are authorized to invest up to 10% of their capital and surplus.

\textsuperscript{335}Kourides, supra note 331, at 352.

\textsuperscript{336}Macey and Miller, supra note 121, at 708.

\textsuperscript{337}12 U.S.C. 1843(C)(14).

\textsuperscript{338}Kourides, supra note 331, at 360.

\textsuperscript{339}Id.

\textsuperscript{340}Macey and Miller, supra note 121, at 710. (Commenting that they do not have FDCI deposit insurance and are designed to accept deposits from foreigners).
subsidiaries, which are required to comply with the norms, regulations and supervision of the host country.

The Office of the Comptroller of the Currency also regulates and supervises some of these activities. It is important to consider that the Glass-Steagall Act which prohibits banks to engage in securities business, does not applies to operations in foreign countries.\textsuperscript{341}

Regarding operations of foreign banks in the U.S, the Board gives authorization before they initiate any type of operation in the country. In this process, the Board looks if in its country of origin, the bank is subject to “comprehensive and consolidated” supervision, the managerial and financial resources, the experience in international operations, the cooperation of the foreign bank regulators and the bank’s capacity to adequate controls in order to comply with U.S. law\textsuperscript{342}. The Foreign Bank Supervision Enhancement Act of 1991 empowered the Board to terminate authorizations of foreign banks if they are not observing the regulations. Additionally, foreign banks are obliged to comply with reserve requirements and they are also provided with deposit insurance\textsuperscript{343}.

5.- Other forms of regulating the system

As mentioned before, most of the traditional tasks performed by the Federal Reserve have a direct or indirect impact on the financial system. In some cases, this function can be considered regulation or intervention over the system.

One of the purposes of the Federal Reserve System is to promote moderate long-term interests.\textsuperscript{344} This goal has a direct impact on the financial system. Besides, the power

\textsuperscript{341}Id.

\textsuperscript{342}Supplement macey at 253

\textsuperscript{343}Juing.

given to the Board of Governors by Congress to determine interest rates mentioned in Chapter VI, is a clear example of regulation over the system.

Monetary policies also have a direct and strong impact on the financial sector. Reserve requirements established by the Federal Reserve, influence the capacity to lend money. The discount window determines the cost of some funds for financial institutions and their availability in some special circumstances.

These traditional central bank functions that are directly focused to adopt and execute monetary policy regulated some of the system’s activities and operations. Regarding Open Market Operations, they have an impact on the system but they cannot be considered a regulation of the system.

Even though the clearing house function is more of a service the Federal Reserve gives to depository institutions, it has a direct effect on the system since it affects the payment system. The Board’s management of these issues is also regulation of the system.

**D. Bank of the Republic**

The Bank of the Republic lacks specific powers to regulate and supervise the Colombian financial system. As already noted, regulation over the system is made by Congress and the Ministry of Finance, while supervision is performed by the Banking Superintendency, which is enclosed in the Ministry of Finance. Despite this consideration, the central bank executes certain duties that involve regulation of the system. Moreover, as any central bank in the world, the Bank of the Republic functions have a direct or indirect impact on the whole system.

As in the Federal Reserve System, adoption and execution of monetary policy and control of inflation rates influence the whole financial system. The power of the Board

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345 COLOM.CONST .art. 372. See also Law 31 of 1992, art. 2.
of Directors of the Bank of the Republic to determine the discount rates and the lines of credit available for financial entities can be consider regulation over the system. In the same way, establishment of reserve requirements over deposits is another example of regulation.

Measures determining ceilings on interest rates in exceptional circumstances and for specifics periods of time are another forms of regulating the system. Open market operation cannot be deemed as regulation of the system, but the effect produced over the system is clear.

Regulations adopted by the Board of Director under its powers as the supreme exchange authority, in some event’s affect the Banks international operations, activities of financial institutions with presence in Colombia and operations of the Banks with foreign investment.

The use of measures regarding clearing house services is another form of regulating the system. Supervision concerning the adoption of these measures by financial institutions is performed by other agencies.

Even though the Bank has some powers to regulate the system, the majority of the regulations are made by the technical Vice Ministry of the Ministry of Finance. The question if the Bank of the Republic should be given regulatory and supervisory function will be address later in this work.

E. Arguments in favor of Regulation and Supervision of the financial system by Central Banks

The question if regulation and supervision of the financial system should be done by central banks has been discussed by scholars. Various arguments against and in favor exist.
The main arguments that support regulation and supervision by central banks are related basically to monetary stability, overlapping of authority and the need for coordination between these functions.

Modern central banks are concentrating more in monetary and price stability. A fragile financial system or a financial crisis will have a negative impact on monetary stability. Moreover, long run price stability produces financial stability. So the conclusion is obvious, central banks must be directly involved in the creation of a healthy and strong financial system and therefore they need to be more involved in their regulation and supervision.

In many industrialized countries one authority regulates banking, securities and insurance. Fewer supervisory institutions exist because of the tendency to universal banking. For some part of the doctrine, central banks should also participate in regulating and supervising the capital market since it also affects monetary and financial stability. This thesis can also be supported if one keeps in mind that recently developments reflect a shift in consumers’ demand from traditional financial institutions to securities and insurance firms. This extreme model has been adopted in countries like Norway and Denmark were there is one regulator and supervisor for everything.

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346 Ruth de Krivov, Central Banks and the Financial System in Latin America, at 3, (Conference on Central Banks in Latin America, Bogota, Col., Feb., 1996) (Stating that it also brings social, political, economical problems, lose of confidence in banks)[hereinafter Krivoy]

347 Alex Cukierman, The Economics of Central Banking, at 33 (for the eleventh World Congress of the International Economic Association, Tunis, Tunisia, Dec, 1995)[hereinafter Cukierman].

348 Krivoy, supra note 346, at 3.

349 Restructuring of Financial Regulation Responsibilities, Federal Reserve Bulletin July 1994 550-53. (Commenting that in Germany, France and Japan, supervisory functions are shared with banking commission or the minister of finance while in United Kingdom, Italy and the Netherlands the Central Bank is the supervisor. In Belgium and Switzerland the central bank is less involve in these) See also Macey and Miller, supra note 121, at 747 (stating that Canada and Japan have separate supervisors for banking and securities activities).

350 Krivoy, supra note 346, at 11.
Another argument in favor is coordination. As already mentioned, monetary stability requires a safe and sound financial system. This can be achieved by giving supervision and regulation to one entity like the central bank or to delegate this functions to separate entities that coordinate in a perfect way.\textsuperscript{351}

Regulation and supervision are effective only if there is a permanent coordination between banking regulators and monetary policy makers. Coordination is essential to anticipate banking crisis and to adopt fast and effective measures. If a panic or crisis occurred, the central bank might have to injected cash or credit in the economy performing its duties of lender of last resort\textsuperscript{352}. These measures can be more useful and preventive if the Central bank has the powers to regulate and supervise. If the central bank lacks these power it has to be permanently involved. In times when countries are experiencing economical or financial difficulties or when there is no coordination between regulators and supervisors with the central bank, it is better to assign this functions to the central bank.\textsuperscript{353}

Another positive aspect of this approach is that it avoids overlapping of jurisdiction and duplication in regulations and supervision that usually occur when separate institutions exist.\textsuperscript{354} Regulation and supervision have to be effective and inexpensive. Besides, in a crisis situation decision have to be adopted fast.

Technology has improved, the market is being liberalized and barriers in the financial market are being eliminated around the world. Besides, financial conglomerates and

\textsuperscript{351} Id.

\textsuperscript{352} C.A.E. Goodhart, \textit{Should the Central Bank Act as Supervisor for Banks}, Financial Market Group, London School of Economics, [hereinafter Goodhart].

\textsuperscript{353} Krivoy, \textit{supra} note 346, at 5.

\textsuperscript{354} Goodhart, \textit{supra} note 352, at 1.
multinational financial institutions are being created. Regulation involves time and expenses. This suggests that regulation must be simplified.\(^{355}\)

Having these responsibilities delegated to the central bank reduces the cost of the government, avoids conflicts between diverse organs of the state, reduces time and increases the effectiveness of the measures adopted. Also, the information collected by supervisors is very useful for a proper adaptation of monetary policies.

Giving these powers to the central bank also produces additional benefits like a more skilled and specialized personnel in these areas that can apply measures with a more professional standard.\(^{356}\) It encourages that decisions will be made more on economical grounds rather than for political reasons.\(^{357}\) Finally, it is the perfect complement for central banking independence.

**F. Arguments against Regulation and Supervision of the financial system by Central Banks**

Regulation and supervision by central bank have several critics. The main concern is that a central bank with these power becomes excessively powerful for a democratic society, especially if it is independent.\(^{358}\) For some scholars, this power will facilitate disguise rescue operations and increase the risk of favoritism.\(^{359}\)

\(^{355}\)C.A.E. Goodhart, *Some Regulatory Concerns*, Financial Market Group, London School of Economics, at 6/10. (also proposing regulation by two bodies. The first one, is the Investor protection body, directed for small investors from threat of insolvency. According to the author, it should be in charge of deposit insurance and focused over small financial institutions. The second body will be the systematic stability which will be empowered to handle issues like capital adequacy and the safety and soundness of the system. This regulatory body will be very important because of the need to have an adequate payment system and because one failure can produce a contagion in other institutions. It will basically concentrate on Banks, Securities and insurance firms. [hereinafter C.A.E. Goodhart]

\(^{356}\)Cukierman, *supra* note 347, at 34/38.

\(^{357}\)Goodhart, *supra* note 352, at 1.

\(^{358}\)C.A.E. Godhart II *supra* note 355, at 37.

\(^{359}\)Goodhart, *supra* note 352, at 2.
Another concern is that monetary policy and banking supervision can conflict in some circumstances. For example, when liquidity problems are affecting the economy, the Central Bank has to focus on its function of lender of last resort instead of price stability. The political pressure over the bank will increase the risks that rescue operation will involve financing by the general public.

There is a theory among some part of the doctrine according to which, even with optimal supervision, bank failures should occur. Under this context, a bank failure, even though it not necessarily negative for the system, will weaken credibility and reputation of the bank, having disastrous effects in the economy. Besides, any failure within the system will be the responsibility of the central bank. This is another reason that will increase the temptation of the central bank to use monetary expansion to solve problems of insolvent banks.

Another negative point is that since banking institutions may participate in financial services activities and in non-banking activities, the central bank will also have to regulate and supervise them. To the same extent it will need these same powers over securities and insurance companies.

Finally, some scholars have found evidence that in countries with a regulator and supervisor separate from the central bank there is less inflation rates.

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360 Cukierman, supra note 347, at 34.

361 Id.

362 C.A.E. Goodhart II, supra note 355, at 37.

363 See Goodhart, supra note 352, at 3. Another example of conflict of interests will be when monetary policy requires high interest rates to control inflation but the financial system is too weak to resist it.

364 Cukierman, supra note 347, at 34.
CHAPTER VI
CONCLUSIONS

As commented in the introduction of this study, there are strong structural differences between the United States and Colombia, like size, economic power, political and legal structure. These differences also are reflected in institutions like the Central Banks and in the financial sector.

The Federal Reserve System is a unique and special system, with participation of the private sector, organized in three levels: Board of Governors of the Federal Reserve, Reserve Banks and Bank Member. Between them, we find the Federal Open Market Committee, an entity with very important and discretionary functions in the managing of the monetary policy, and with public and private participation.

Colombia’s Central Bank has a more simple structure and only public interests are represented. The system consists of the Bank itself, the Board of Directors of the Bank and the General Manager.

The Federal Reserve System was originated in a law passed by the Congress in the use of its Constitutional powers. The Bank of the Republic had also legal status, but since 1991 was given constitutional status. The Federal Reserve System has been amended on several occasions but its structure continues to be the same as the one established by the Federal Reserve Act of 1913. On the other hand, Colombia’s system has been modified in a structural way a great number of times due to deep political changes. From my point of view, this instability reflects in a negative way on the economy and even though modifications have to be made in accordance with economical changes, the structure of a legal entity must be kept for a long period of time in order to be developed in a positive
way. Probably that was one of the reasons to give the Central Bank constitutional status. The new system adopted in the 1991 Colombian Constitution, will be very difficult to change and this way it will probably develop in a natural way.

Another difference between the two systems relates to the Board. The period of the members of the American Board of Governors is superior to the Colombian Board of Directors. This situation gives more stability for policies adopted.

The American Senate participates in the appointment process by advising and consenting while in Colombia, neither the Senate nor the House of Representatives is involved in the process. I think that in order to have less political interference in these important areas, it is better that the Congress does not play any role in this process.

Other differences with less importance are for example that in the Colombian System the President of the Board is the Minister of Finance. In the United States, the Chairman of the Board is appointed by the president and the Secretary of Treasury is not part of the Board. Having a member of the government on the Board lessens the independence of the decisions but helps to have a more coordinated economic policy.

We can also find similarities between theses two Central Banks. Both Central Banks systems play a very important role in the regulation of the economy, were created in the beginning of the century, and have a relative strong independence from the government and other powers. The American and the Colombian systems have discretionary powers to regulate their areas', they have patrimonial autonomy and they make reports to Congress.

The President participates in a direct way in the appointing process in both systems and members of the Board need to have special skill qualifications and must be dedicated completely to the Board. The Federal Reserve System and the Bank of the Republic have
adapted to the evolution and changes in the banking system, gaining a more predominant role in the regulation of the economy.\textsuperscript{365}

Central Banks have a particular role in the regulation of the economy. The main functions of modern central banks are to control monetary policy and price stability. Monetary policy is the mechanism designed to influence and control the supply and use of money.\textsuperscript{366}

In the American system, the principal way of making monetary policy is by the Open Market Operations. In Colombia, this mechanism is starting to develop in a very important way. Open Market Operations have the advantage that they can be adopted by the Central Bank whenever is needed and at its own discretion.\textsuperscript{367}

Regulation of the financial system can be understood as the formulation by authorized agencies of specific rules for the conduct of banking. These rules must promote healthy practices for the correct practice of the business of banking. Undertaking of Open Market Operations by the Federal Reserve or by the Bank of the Republic affects the normal course of the financial system, but it cannot be considered regulation.

Other important instruments for monetary policy making are reserve requirements on deposits and discount operations. Reserve requirements have a very fast impact in the liquidity of the financial system and costs in the economy. In the U.S., since the Banking Act and the Garn-St. Germain Depository Institutions Act were passed, reserve requirements apply equally to members and non-members institutions. This particular situation makes this mechanism very important. In Colombia, the Board of Directors of

\textsuperscript{365} Aman, supra note 20, at 843.

\textsuperscript{366} Haggot, supra note 13, at 484.

\textsuperscript{367} Ritter and Silber, supra note 69, at 215.
the Bank of the Republic is empowered to establish and regulate the reserve requirements that credit institutions must have in the different kinds of deposits.\footnote{Law 31 of 1992, art.16, lit.a.}

Concerning discount operations, they are considered also an important instrument for making monetary policy and are a clear manifestation of Central Banks as lenders of last resort. The Federal Reserve System and the Board of Directors of the Bank of the Republic are in charge of determining rates and conditions for discount operations. Both reserve requirements and discount operations affect and influence in a direct and essential way affecting their capacity to lend and the availability and cost of some funds in special circumstances. These two operations are clear examples of regulation over the system.

Other functions performed by the Federal Reserve System and the Bank of the Republic, like determining ceiling on interest rates, regulating clearing house services and adopting some exchange policy measures can also be considered regulation of the financial system.

Supervision is as an action undertaken by authorized agencies with the basic purpose of determining if banks, other depository institutions, and financial institutions are operating in accordance with the law and regulations. Supervision is essential to provide the system with security, transparency, confidence and security. It also helps to avoid abuses, crisis and panics.

For part of the central banking doctrine, supervision and regulation of the financial system should be made by the central banks since there is a strong relation with these functions and monetary stability. Also because duplication and overlapping are avoided and solutions to problems can be adopted faster. Other advantages of this model are that government costs are reduced, conflicts between organs of the state are eluded, decisions
are made more on economical grounds and it is the perfect complement for central banking independence.

Supervision and regulation of the financial system by central banks is also criticized by some scholars. The main reasons for these critics are that the bank becomes too powerful for a democratic society, monetary policy might conflict with regulation and supervision, and there is a higher risk that panics and failures will be solved by monetary expansion. Moreover, the Central Bank will have to regulate all kinds of financial services and non-banking activities and in case of a failure or a financial crisis the bank will be held responsible, losing its credibility and having a very negative effect in the economy.

The American regulatory and supervisory system over the financial system is very complex. It is composed of several agencies empowered by Congress in various laws, with different jurisdictions and sometimes with overlapping authority. The most representative federal agencies in these fields are the Federal Reserve, the Comptroller of the Currency, the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision and the fifty-one State regulators and supervisors.

The Federal Reserve is one of the regulators and supervisors of the system. Among other functions, the central bank approves the admission and regulates state member banks. It has the power to approve bank mergers and acquisitions and regulates and approves activities and operations of bank holding companies. The Federal Reserve also approves, regulates and supervises international activities of U.S. banks and activities of foreign banks in the U.S.

In Colombia, the 1991 Constitution provided a dual form of regulation. The regulation of the financial sector is performed by Congress and the Ministry of Finance. Supervision is a responsibility of the President which delegated this faculty to the
Banking Superintendency. The Bank of the Republic lacks any specific or express functions as regulator or supervisor of the system besides the traditional central banking activities.

The financial system in the United States and in Colombia is changing very rapidly. International agreements on financial services are being subscribed by various countries like in the European Community and the North American Free Trade Agreements. International standards for banking supervision have been settled by the Basle Committee. The World Trade Organization has recently subscribed an agreement on services that might cover financial activities. There is a tendency to internationalization and globalization of the system and to the adoption of universal banking schemes.

Technology, specially in computers and in communication, has revolutionized the financial market. The system is being liberalized and barriers are being eliminated around the world. Financial conglomerates and multinational financial institutions are also being created.

Since regulation and supervision involves time and expenses it is necessary to simplify it and to adopt general rules applicable to all kinds of institutions. Regulation and supervision of financial systems and related markets cannot be insulated from the Central Banks because they are responsible for the stability of the system.

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369Decree 1284 of 1994, art.2

370.C.A.E. Goodhart, supra note 355, at 6-10/15( the author proposed regulation by two bodies. The first one, is the Investor protection body, directed for small investors from threaten of insolvency. According to the author, it should be in charge of deposit insurance and focused over small financial institutions. The second body will be the systematic stability which will be empowered to handle issues like capital adequacy and the safety and soundness of the system. This regulatory body will be very important because of the need to have an adequate payment system and because one failure can produce a contagion in other institutions. It will basically concentrate on Banks, Securities and insurance firms.

This brings us to the ultimate questions. Should the Federal Reserve System functions as regulators or supervisors be abolish? Should the Bank of the Republic be empowered to regulate or supervise the system? Should regulation be simplified?

Recently, the Clinton administration proposed the creation of a single entity that charters, supervises and regulates all banks, thrifts, holding companies, and foreign bank activities in the U.S. This entity will be called the Federal Banking Commission. Under the Government’s proposal, the FDIC will keep the administration of deposit funds and the Federal Reserve System will keep its central bank’s function. 372

The Federal Reserve opposed strongly the government’s proposal arguing that supervision and regulation by a single regulator will destroy the dual banking system, will disconnect the system from macroeconomic policy affecting growth and stability and will reduce the ability to control and avoid crisis. 373 According to the Federal Reserve, Central Banks should be involved directly in supervision and regulation of the system. Otherwise, it will become just an academic institution 374. Finally, they proposed that regulatory and supervisory functions should be given to two federal entities to avoid duplicative supervision. 375, one of them the Federal Reserve. In this way, the Federal Reserve will maintain its functions and regulation and supervision will be simplified.

The Government proposal was not passed in Congress but the discussion still remains. 376 The problem of having several regulators and supervisors, like in the United

372Muckenfuss, supra note 264, at 3.  
374Id. According to the Federal Reserve, in all countries of the G-7 except Canada the Central bank is involved in regulation and supervision of the banking system.  
375Id at 384.  
376Muckenfuss, supra note 264, at 3.
States, is that shopping for the more permissive agency is promoted, costs are higher, and overlapping and duplicative examination exists.

There is no doubt that the American regulatory and supervisory system needs to be simplified, specifically if one takes into account all the deep changes occurring lately in the system. There are too many entities with overlapping jurisdictions and duplication is evident.

This does not mean that the functions performed by the Reserve System should be eliminated. The Federal Reserve must continue to be involved in order to have a sound financial system\textsuperscript{377}.

But the creation of another regulator is necessary to maintain balance and equilibrium\textsuperscript{378}. In my opinion, the proposal by the Board of having two federal entities in charge is very attractive. The Central Bank will continue with its regulatory and supervisory function and monetary stability will not be risk. On the other side, the creation of another entity, like a banking commission will produce many benefits, because it will eliminate duplication and overlapping. It will promote efficiency, reduce costs and time and will create a balance of powers over the system.

In Colombia, the situation is a little different. Even though the financial system is developing faster every day, political, economical and social problems have sometimes interrupted this process. A fragile financial system or a financial crisis will have a very negative impact on monetary stability. Moreover, long term price stability produces

\textsuperscript{377} Restructuring of Financial Regulation Responsibilities, Federal Reserve Bulletin, 551, July 1994. (also commenting that is a responsibility of Central Banks to have an efficient payment system. Monetary policy can be affected by disturbances of financial markets. Regulatory policies have a great impact for monetary policy and for the stability of the system.

\textsuperscript{378} Id at 552.
financial stability. In Latin America, and particularly in Colombia, this situation is possible since these societies are in transition.\(^{379}\)

The Banking Superintendency, is presently doing a very good job in supervising the system. Regulation is made essentially by the Technical Vice Ministry of Finance. Regulation and supervision in the hands of the government gives him too much power over the system. I think it should be healthy for the system to have regulation by the central bank. Supervision can continue to be performed by the Banking Superintendency. This approach will have very positive effects because it will balance the powers and neither the Board nor the government will have total autonomy over the system. Besides, this suggestion will reduce costs, avoids potentially duplication and overlapping, promote monetary stability, fortify independence, improve efficiency, eliminate possibilities of conflict of interests and encourage decisions based more on economic rather than political grounds. A Constitutional reform will be needed to make such a modification.

\(^{379}\)Krivoy, supra note 346, at 3.
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