

# 1 Overview of the Federal Reserve System

*The Federal Reserve System is the central bank of the United States. It was founded by Congress in 1913 to provide the nation with a safer, more flexible, and more stable monetary and financial system. Over the years, its role in banking and the economy has expanded.*

Today, the Federal Reserve's duties fall into four general areas:

- conducting the nation's monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates
- supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers
- maintaining the stability of the financial system and containing systemic risk that may arise in financial markets
- providing financial services to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation's payments system

Most developed countries have a central bank whose functions are broadly similar to those of the Federal Reserve. The oldest, Sweden's Riksbank, has existed since 1668 and the Bank of England since 1694. Napoleon I established the Banque de France in 1800, and the Bank of Canada began operations in 1935. The German Bundesbank was reestablished after World War II and is loosely modeled on the Federal Reserve. More recently, some functions of the Banque de France and the Bundesbank have been assumed by the European Central Bank, formed in 1998.

## Background

During the nineteenth century and the beginning of the twentieth century, financial panics plagued the nation, leading to bank failures and business bankruptcies that severely disrupted the economy. The failure of the nation's banking system to effectively provide funding to troubled depository institutions contributed significantly to the economy's vulnerability to financial panics. Short-term credit is an important source of liquidity when a bank experiences unexpected and widespread withdrawals during a financial panic. A particularly severe crisis in 1907 prompted

Congress to establish the National Monetary Commission, which put forth proposals to create an institution that would help prevent and contain financial disruptions of this kind. After considerable debate, Congress

passed the Federal Reserve Act “to provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes.” President Woodrow Wilson signed the act into law on December 23, 1913.

Soon after the creation of the Federal Reserve, it became clear that the act had broader implications for national economic and financial policy. As time has passed, further legislation has clarified and supplemented the original purposes. Key laws affecting the Federal Reserve have been the Banking Act of 1935; the Employment Act of 1946; the Bank Holding Company Act of 1956 and the amendments of 1970; the International Banking Act of 1978; the Full Employment and Balanced Growth Act of 1978; the Depository Institutions Deregulation and Monetary Control Act of 1980; the Financial Institutions Reform, Recovery, and Enforcement Act of 1989; the Federal Deposit Insurance Corporation Improvement Act of 1991; and the Gramm-Leach-Bliley Act of 1999. Congress has also adopted legislation defining the primary objectives of national economic policy, including the Employment Act of 1946; the Federal Reserve Reform Act of 1977; and the Full Employment and Balanced Growth Act of 1978, which is sometimes called the Humphrey-Hawkins Act, after its original sponsors. These objectives include economic growth in line with the economy’s potential to expand; a high level of employment; stable prices (that is, stability in the purchasing power of the dollar); and moderate long-term interest rates.



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The Federal Reserve System is considered to be an independent central bank because its decisions do not have to be ratified by the President or

anyone else in the executive branch of government. The System is, however, subject to oversight by the U.S. Congress. The Federal Reserve must work within the framework of the overall objectives of economic and financial policy established by the government; therefore, the description of the System as “independent within the government” is more accurate.

## Structure of the System

Congress designed the structure of the Federal Reserve System to give it a broad perspective on the economy and on economic activity in all parts of the nation. It is a federal system, composed of a central, governmental agency—the Board of Governors—in Washington, D.C., and twelve regional Federal Reserve Banks. The Board and the Reserve Banks share responsibility for supervising and regulating certain financial institutions and activities, for providing banking services to depository institutions and the federal government, and for ensuring that consumers receive adequate information and fair treatment in their business with the banking system.

A major component of the System is the Federal Open Market Committee (FOMC), which is made up of the members of the Board of Governors, the president of the Federal Reserve Bank of New York, and presidents of four other Federal Reserve Banks, who serve on a rotating basis. The FOMC oversees open market operations, which is the main tool used by the Federal Reserve to influence overall monetary and credit conditions. These operations are described in greater detail in chapter 3.

The Federal Reserve implements monetary policy through its control over the federal funds rate—the rate at which depository institutions trade balances at the Federal Reserve. It exercises this control by influencing the demand for and supply of these balances through the following means:

- Open market operations—the purchase or sale of securities, primarily U.S. Treasury securities, in the open market to influence the level of balances that depository institutions hold at the Federal Reserve Banks
- Reserve requirements—requirements regarding the percentage of certain deposits that depository institutions must hold in reserve in the form of cash or in an account at a Federal Reserve Bank
- Contractual clearing balances—an amount that a depository institution agrees to hold at its Federal Reserve Bank in addition to any required reserve balance
- Discount window lending—extensions of credit to depository institutions made through the primary, secondary, or seasonal lending programs

Two other groups play roles in the functioning of the Federal Reserve Sys-

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tem: depository institutions, through which monetary policy operates, and advisory committees, which make recommendations to the Board of Governors and to the Reserve Banks regarding the System's responsibilities.

## Board of Governors

The Board of Governors of the Federal Reserve System is a federal government agency. The Board is composed of seven members, who are appointed by the President of the United States and confirmed by the U.S. Senate. The full term of a Board member is fourteen years, and the appointments are staggered so that one term expires on January 31 of each even-numbered year. After serving a full term, a Board member may not be reappointed. If a member leaves the Board before his or her term expires, however, the person appointed and confirmed to serve the remainder of the term may later be reappointed to a full term.



The first Federal Reserve Board, 1914

The Chairman and the Vice Chairman of the Board are also appointed by the President and confirmed by the Senate. The nominees to these posts must already be members of the Board or must be simultaneously appointed to the Board. The terms for these positions are four years.

The Board of Governors is supported by a staff in Washington, D.C., numbering about 1,800 as of 2004. The Board's responsibilities require thorough analysis of domestic and international financial and economic developments. The Board carries out those responsibilities in conjunction with other components of the Federal Reserve System. The Board of Governors

also supervises and regulates the operations of the Federal Reserve Banks, exercises broad responsibility in the nation's payments system, and administers most of the nation's laws regarding consumer credit protection.

Policy regarding open market operations is established by the FOMC. However, the Board of Governors has sole authority over changes in reserve requirements, and it must approve any change in the discount rate initiated by a Federal Reserve Bank.

The Board also plays a major role in the supervision and regulation of the U.S. banking system. It has supervisory responsibilities for state-chartered banks that are members of the Federal Reserve System, bank holding companies (companies that control banks), the foreign activities of member banks, the U.S. activities of foreign banks, and Edge Act and agreement corporations (limited-purpose institutions that engage in a foreign banking business). The Board and, under delegated authority, the Federal

Reserve Banks, supervise approximately 900 state member banks and 5,000 bank holding companies. Other federal agencies also serve as the primary federal supervisors of commercial banks; the Office of the Comptroller of the Currency supervises national banks, and the Federal Deposit Insurance Corporation supervises state banks that are not members of the Federal Reserve System.

Some regulations issued by the Board apply to the entire banking industry, whereas others apply only to member banks, that is, state banks that have chosen to join the Federal Reserve System and national banks, which by law must be members of the System. The Board also issues regulations to carry out major federal laws governing consumer credit protection, such as the Truth in Lending, Equal Credit Opportunity, and Home Mortgage Disclosure Acts. Many of these consumer protection regulations apply to various lenders outside the banking industry as well as to banks.

Members of the Board of Governors are in continual contact with other policy makers in government. They frequently testify before congressional committees on the economy, monetary policy, banking supervision and regulation, consumer credit protection, financial markets, and other matters. For instance, as required by the Federal Reserve Act, the Chairman of the Board of Governors testifies before the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services on or about February 20 and July 20 of each year. The Chairman's testimony addresses the efforts, activities, objectives, and plans of the Board of Governors and the Federal Open Market Committee with respect to the conduct of monetary policy, as well as economic developments in the United States and the prospects for the future. Concurrently, the Board of Governors must submit a report on these same issues to the House and Senate committees before which the Chairman testifies.

The Board has regular contact with members of the President's Council of Economic Advisers and other key economic officials. The Chairman also meets from time to time with the President of the United States and has regular meetings with the Secretary of the Treasury.

The Chairman has formal responsibilities in the international arena as well. For example, he is the alternate U.S. member of the board of governors of the International Monetary Fund, a member of the board of the Bank for International Settlements (BIS), and a member, along with the heads of other relevant U.S. agencies and departments, of the National Advisory Council on International Monetary and Financial Policies. He is also a member of U.S. delegations to key international meetings, such as those of the finance ministers and central bank governors of the seven largest industrial countries—referred to as the Group of Seven, or G-7. He, other Board members, and Board staff members share many inter-

national responsibilities, including representing the Federal Reserve at meetings at the BIS in Basel, Switzerland, and at the Organisation for Economic Co-operation and Development in Paris, France.

One member of the Board of Governors serves as the System's representative to the Federal Financial Institutions Examination Council (FFIEC), which is responsible for coordinating, at the federal level, examinations of depository institutions and related policies. The FFIEC has representatives from the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision, as well.

The Board publishes detailed statistics and other information about the System's activities and the economy in publications such as the quarterly *Federal Reserve Bulletin*, the monthly *Statistical Supplement*, and separate statistical releases. Through the *Federal Reserve Regulatory Service*, it provides materials relating to its regulatory and supervisory functions. Extensive information about the Board of Governors is available on the Board's web site ([www.federalreserve.gov](http://www.federalreserve.gov)), including the testimony and speeches of Board members; actions on banking and consumer regulations and other matters; and statistics and research papers concerning economic, banking, and financial matters.

*The Reserve Banks are the operating arms of the central banking system.*

The Board is audited annually by a major public accounting firm. In addition, the Government Accountability Office (GAO) generally exercises its authority to conduct a number of reviews each year to look at specific aspects of the Federal Reserve's activities. The audit report of the public accounting firm and a complete list of GAO reviews under way are available in the Board's *Annual Report*, which is sent to Congress during the second quarter of each calendar year. Monetary policy is exempt from audit by the GAO because it is monitored directly by Congress through written reports, including the semiannual *Monetary Policy Report to the Congress*, prepared by the Board of Governors.

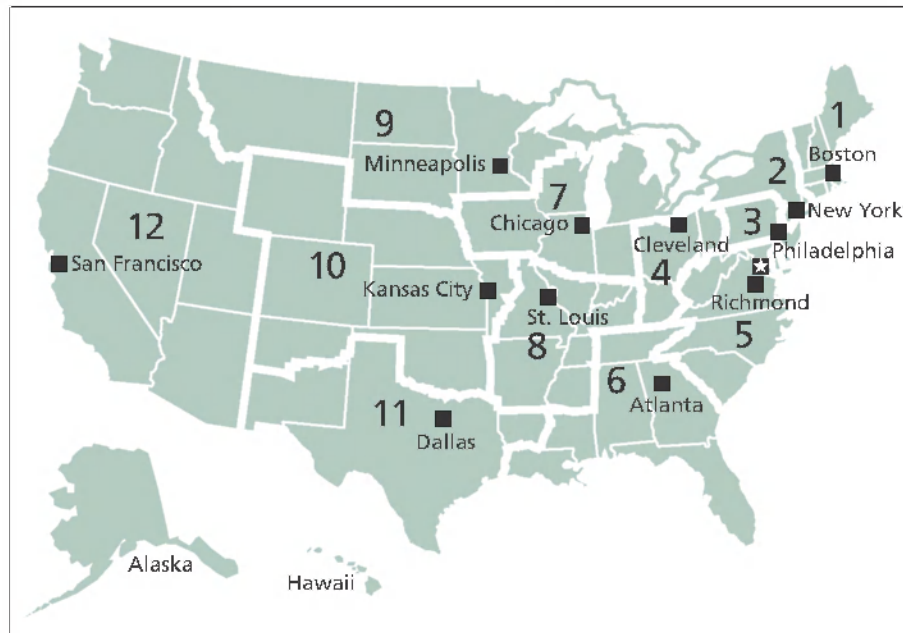
## **Federal Reserve Banks**

A network of twelve Federal Reserve Banks and their Branches (twenty-five as of 2004) carries out a variety of System functions, including operating a nationwide payments system, distributing the nation's currency and coin, supervising and regulating member banks and bank holding companies, and serving as banker for the U.S. Treasury. The twelve Reserve Banks are each responsible for a particular geographic area or district of the United States. Each Reserve District is identified by a number and a letter (see the list of District offices on page 7). Besides carrying out functions for the System as a whole, such as administering nationwide banking and credit policies, each Reserve Bank acts as a depository for the banks in its own District and fulfills other District responsibilities. The various

## Federal Reserve District Banks and Branches

Number	Letter	Bank	Branch
1	A	Boston	
2	B	New York	Buffalo, New York
3	C	Philadelphia	
4	D	Cleveland	Cincinnati, Ohio Pittsburgh, Pennsylvania
5	E	Richmond	Baltimore, Maryland Charlotte, North Carolina
6	F	Atlanta	Birmingham, Alabama Jacksonville, Florida Miami, Florida Nashville, Tennessee New Orleans, Louisiana
7	G	Chicago	Detroit, Michigan
8	H	St. Louis	Little Rock, Arkansas Louisville, Kentucky Memphis, Tennessee
9	I	Minneapolis	Helena, Montana
10	J	Kansas City	Denver, Colorado Oklahoma City, Oklahoma Omaha, Nebraska
11	K	Dallas	El Paso, Texas Houston, Texas San Antonio, Texas
12	L	San Francisco	Los Angeles, California Portland, Oregon Salt Lake City, Utah Seattle, Washington

## The Federal Reserve System



### Legend

- Federal Reserve Bank city
- ⊠ Board of Governors of the Federal Reserve System, Washington, D.C.
- Federal Reserve Branch city
- Branch boundary

### Notes

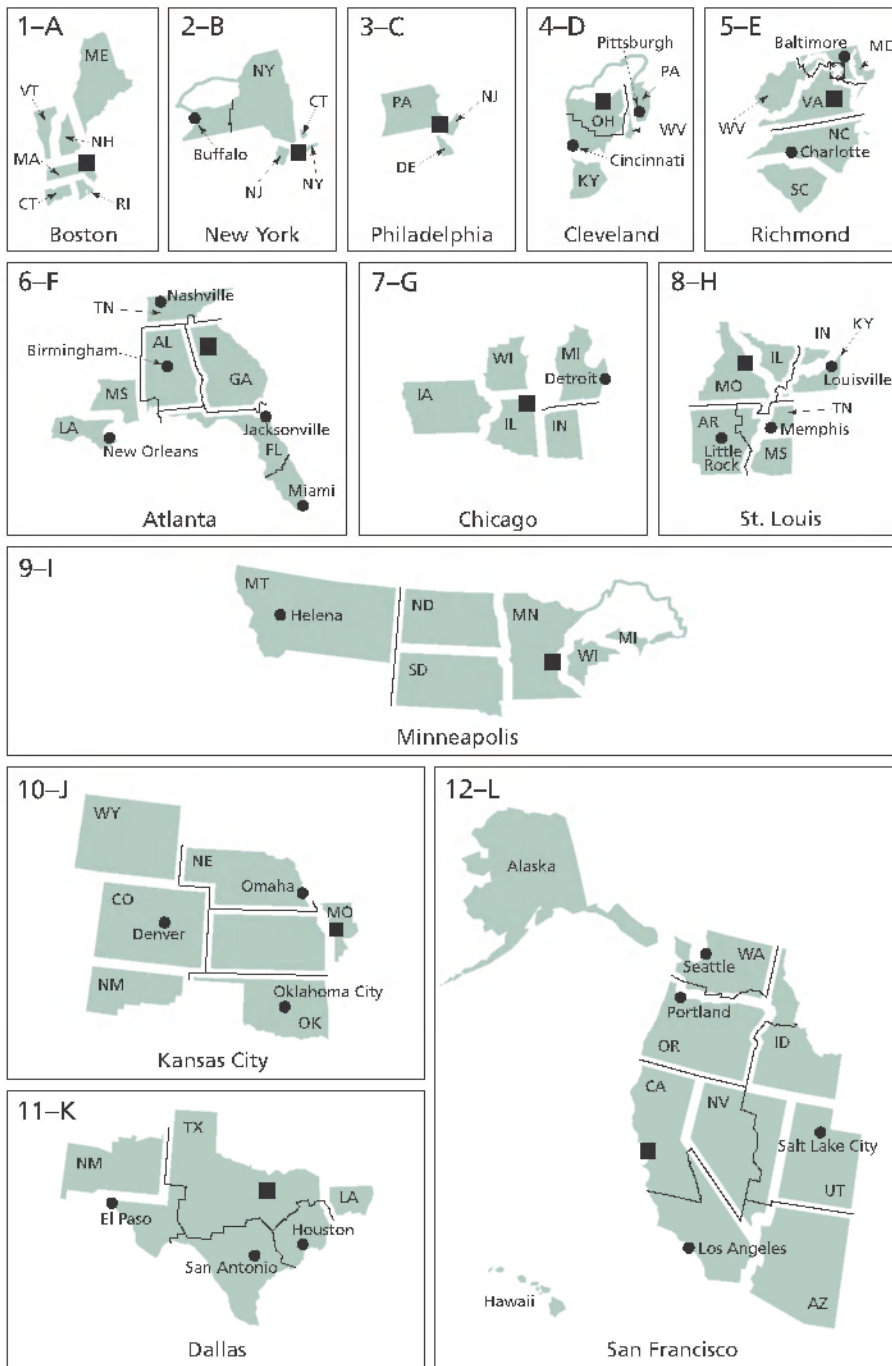
The Federal Reserve officially identifies Districts by number and by Reserve Bank city (shown on both pages) as well as by letter (shown on the facing page).

In the 12th District, the Seattle Branch serves Alaska and the San Francisco Bank serves Hawaii.

The New York Bank serves the Commonwealth of Puerto Rico and the U.S. Virgin Islands; the San Francisco Bank serves American Samoa, Guam, and the Commonwealth of the Northern Mariana Islands.

The Board of Governors revised the Branch boundaries of the System most recently in February 1996.





offices and boundaries of the Federal Reserve Districts are shown on the maps on pages 8 and 9.

The Board of Governors has broad oversight responsibility for the operations and activities of the Federal Reserve Banks and their Branches. This authority includes oversight of the Reserve Banks' services to banks and other depository institutions and of their examination and supervision of various banking institutions. Each Federal Reserve Bank must submit its annual budget to the Board of Governors for approval. Particular types of expenditures—such as those for construction or major alterations of Reserve Bank buildings and for the salaries of Reserve Bank presidents and first vice presidents—also are subject to specific Board approval.

Congress chartered the Federal Reserve Banks for a public purpose. The Reserve Banks are the operating arms of the central banking system, and they combine both public and private elements in their makeup and organization. As part of the Federal Reserve System, the Banks are subject to oversight by Congress.

Each Reserve Bank has its own board of nine directors chosen from outside the Bank as provided by law. The boards of the Reserve Banks are intended to represent a cross-section of banking, commercial, agricultural, industrial, and public interests within the Federal Reserve District. Three directors, designated Class A directors, represent commercial banks that are members of the Federal Reserve System. Three Class B and three Class C directors represent the public. The member commercial banks in each District elect the Class A and Class B directors. The Board of Governors appoints the Class C directors to their posts. From the Class C directors, the Board of Governors selects one person as chairman and another as deputy chairman. No Class B or Class C director may be an officer, director, or employee of a bank or a bank holding company. No Class C director may own stock in a bank or a bank holding company. The directors in turn nominate a president and first vice president of the Reserve Bank, whose selection is subject to approval by the Board of Governors. Each Branch of a Reserve Bank has its own board of directors composed of at least three and no more than seven members. A majority of these directors are appointed by the Branch's Reserve Bank; the others are appointed by the Board of Governors.

Boards of directors of the Reserve Banks provide the Federal Reserve System with a wealth of information on economic conditions in virtually every corner of the nation. This information is used by the FOMC and the Board of Governors in reaching major decisions about monetary policy. Information from directors and other sources gathered by the Reserve Banks is also shared with the public in a special report—informally called the Beige Book—which is issued about two weeks

before each meeting of the FOMC. In addition, every two weeks, the board of each Bank must recommend interest rates for its Bank's discount window lending, subject to review and determination by the Board of Governors.

The income of the Federal Reserve System is derived primarily from the interest on U.S. government securities that it has acquired through open market operations. Other major sources of income are the interest on foreign currency investments held by the System; interest on loans to depository institutions; and fees received for services provided to depository institutions, such as check clearing, funds transfers, and automated clearinghouse operations.

After it pays its expenses, the Federal Reserve turns the rest of its earnings over to the U.S. Treasury. About 95 percent of the Reserve Banks' net earnings have been paid into the Treasury since the Federal Reserve System began operations in 1914. (Income and expenses of the Federal Reserve Banks from 1914 to the present are included in the *Annual Report* of the Board of Governors.) In 2003, the Federal Reserve paid approximately \$22 billion to the Treasury.

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The Board of Governors contracts with an accounting firm to conduct an audit of the Reserve Banks every year, and Board staff periodically reviews the operations of the Reserve Banks in key functional areas. The audited combined financial statements of the Reserve Banks are published in the Board's *Annual Report*. The Reserve Banks, like the Board, are subject to audit by the GAO, but certain functions, such as transactions with foreign central banks and open market operations, are excluded from the GAO's audit. Each Reserve Bank has an internal auditor who is responsible to the Bank's board of directors.

### **Federal Open Market Committee**

The FOMC is charged under law with overseeing open market operations, the principal tool of national monetary policy. These operations affect the amount of Federal Reserve balances available to depository institutions (see chapter 3), thereby influencing overall monetary and credit conditions. The FOMC also directs operations undertaken by the Federal Reserve in foreign exchange markets.

The FOMC is composed of the seven members of the Board of Governors and five of the twelve Reserve Bank presidents. The president of the Federal Reserve Bank of New York is a permanent member; the other

presidents serve one-year terms on a rotating basis.<sup>1</sup> All the presidents participate in FOMC discussions, contributing to the committee's assessment of the economy and of policy options, but only the five presidents who are committee members vote on policy decisions. The FOMC, under law, determines its own internal organization and by tradition elects the Chairman of the Board of Governors as its chairman and the president of the Federal Reserve Bank of New York as its vice chairman. Formal meetings typically are held eight times each year in Washington, D.C. Telephone consultations and other meetings are held when needed.

### Member Banks

The nation's commercial banks can be divided into three types according to which governmental body charters them and whether or not they are members of the Federal Reserve System. Those chartered by the federal government (through the Office of the Comptroller of the Currency in the Department of the Treasury) are national banks; by law, they are members of the Federal Reserve System. Banks chartered by the states are divided into those that are members of the Federal Reserve System (state member banks) and those that are not (state nonmember banks). State banks are not required to join the Federal Reserve System, but they may elect to become members if they meet the standards set by the Board of Governors. As of March 2004, of the nation's approximately 7,700 commercial banks approximately 2,900 were members of the Federal Reserve System—approximately 2,000 national banks and 900 state banks.

Member banks must subscribe to stock in their regional Federal Reserve Bank in an amount equal to 6 percent of their capital and surplus, half of which must be paid in while the other half is subject to call by the Board of Governors. The holding of this stock, however, does not carry with it the control and financial interest conveyed to holders of common stock in for-profit organizations. It is merely a legal obligation of Federal Reserve membership, and the stock may not be sold or pledged as collateral for loans. Member banks receive a 6 percent dividend annually on their stock, as specified by law, and vote for the Class A and Class B directors of the Reserve Bank. Stock in Federal Reserve Banks is not available for purchase by individuals or entities other than member banks.

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1. The rotating seats are filled from the following four groups of Banks, one Bank president from each group: Boston, Philadelphia, and Richmond; Cleveland and Chicago; Atlanta, St. Louis, and Dallas; and Minneapolis, Kansas City, and San Francisco. An alternate for each Reserve Bank president also is elected. This alternate, who must be a president or first vice president of a Reserve Bank, may serve on the FOMC in the absence of the relevant Reserve Bank president.