

# CRS Report for Congress

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## Structure and Functions of The Federal Reserve System

Pauline Smale  
Economic Analyst  
Government and Finance Division

### Summary

In 1913, Congress created the Federal Reserve System to serve as the central bank for the United States. The Federal Reserve formulates the nation's monetary policy, supervises and regulates banks, and provides a variety of financial services to depository financial institutions and the federal government. The System comprises three major components, the Board of Governors, a network of 12 Federal Reserve Banks, and member banks.

Congress created the Federal Reserve as an independent agency to enable the central bank to carry out its responsibilities protected from excessive political and private pressures. At the same time, by law and practice, the Federal Reserve is accountable to Congress. The seven members of the board are appointed by the President with the advice and consent of the Senate. Congress routinely monitors the Federal Reserve System through formal and informal oversight activities.

This report examines the structure and operations of the major components of the Federal Reserve System, and provides an overview of congressional oversight activities. This report will be updated in the event of a change in the structure or functions of the Federal Reserve System.

### Background

The U.S. central banking system was established in 1913 by the Federal Reserve Act (P.L. 63-43). Congress created the Federal Reserve (popularly known as the "Fed") as an independent entity to attend to the nation's credit and monetary needs without undue influence from political pressures. Today, the Fed's monetary policy operations are intended to promote stability in the nation's economy; its supervisory and regulatory functions are intended to provide a safer, more flexible banking system; and its work as fiscal agent for the government and clearinghouse for private sector financial transactions promotes efficiency in the overall banking system. In keeping with its independence within the federal government, the System operates without appropriations from Congress. Its income derives primarily from interest on government securities acquired

through monetary policy operations, and fees for banking services, with any excess income returned to the Treasury.

The current structure of the System has three major components established by the original act. First, a Board of Governors oversees the whole System and has responsibility for monetary policy. Second, there are 12 regional Federal Reserve Banks, which carry out supervision and examination of commercial banks that are Fed members. The member banks, all national banks and all state-chartered banks that choose to be members of the System, make up the third component.

## **Board of Governors**

The Board of Governors of the Federal Reserve System was established as a federal government agency. The Administration and Congress can have a significant influence on the Fed through control over appointments to the seven-member board. Each of the seven governors is appointed by the President, with the advice and consent of the Senate. The full term of service for a board seat is 14 years and governors may be named to a seat at any point during the term. The appointments are staggered with one term expiring every two years. Governors serving a full term may not be reappointed. Two members hold the leadership positions of chairman and vice chairman of the board. They are designated by the President, with the advice and consent of the Senate. The term of service for both leadership offices is four years; an office holder may be reappointed. These terms do not coincide with that of the President or each other. While the board chairman is considered quite powerful, each governor has one vote on the board.

When selecting a governor, the President must give due regard to a fair representation of financial, agricultural, industrial, and commercial interests, and geographical divisions of the country. No more than one governor can be selected from any one Federal Reserve district. The members of the Board of Governors cannot hold any office, position, or employment in any member bank during the time they are in office and for two years after.

Currently, all seven positions are filled but three spots will open over the next eight months. The board chairman is Alan Greenspan; he will not complete his current term as chairman because his term as governor expires in 2006. Governor Ben S. Bernanke has been nominated to be the next chairman of the White House Council of Economic Advisors and will remain at the Federal Reserve until confirmed. Governor Bernanke is serving a term that ends in 2018. Governor Edward M. Gramlich has announced that he will resign at the end of August 2005, he is serving in a term that ends in 2008. The vice chairman is Roger W. Ferguson, whose term as vice chairman expires in 2007 and whose term as governor ends in 2014. Governor Mark W. Olson is serving in a term that ends in 2010. Governor Susan Schmidt Bies is serving a full term that ends in 2012. Governor Donald L. Kohn is serving a full term that ends in 2016.

## **Monetary Policy**

The primary responsibility of the Board of Governors of the Federal Reserve System is the formulation of monetary policy. In broad terms, monetary policy involves increasing and decreasing the supply of money and, therefore, interest rates to achieve

macroeconomic objectives. The Federal Reserve uses economic instruments to alter the availability and cost of money and credit. In general, the long-term goal of monetary policy is to ensure that money and credit grow sufficiently to encourage non-inflationary economic expansion. When economic problems arise, such as the prospect of an economic downturn, attention can quickly focus on the Fed's policy decisions.<sup>1</sup>

The Federal Open Market Committee (FOMC) is the policy making body for open market operations — the principal means through which monetary policy is conducted. The seven board members plus five of the 12 Federal Reserve Bank presidents make up the FOMC. The president of the Federal Reserve Bank of New York is a permanent member because the New York Bank executes the Fed's monetary policy decisions through open market operations. The remaining four seats are filled by the other 11 presidents on a rotating basis for one-year terms. All of the presidents participate in the FOMC meetings and contribute their views but only the five members vote. The committee elects a chairman and vice chairman. Traditionally, the chairman of the Board of Governors is elected chairman and the New York Bank's president is elected vice chairman.

Open market operations involve the purchase and sale of government securities in the secondary market by the Federal Reserve. Payments for purchases of securities by the Federal Reserve increase the money supply and this tends to ease credit conditions. When securities are sold by the Federal Reserve the money supply is decreased and credit conditions are tightened. The Federal Reserve System's portfolio is composed of U.S. Treasury securities, federal agency securities, and bankers acceptances. The Federal Reserve Bank of New York holds the portfolio and through its trading desk conducts open market operations pursuant to directives of the FOMC.

Two less often used monetary policy instruments may be employed by the Federal Reserve — legal reserve requirements and the discount window. Depository financial institutions are required by law to set aside reserves in certain proportions against demand deposits. What is held in reserve affects the availability of loanable funds. An increase in the requirement would mean banks and thrifts would have less money to lend and would tend to restrain the money supply. Alternatively, lowering the requirement would increase the proportion of deposits that could be lent and would tend to expand the money supply. Reserve requirements are rarely changed because as a monetary policy tool they are considered too blunt an instrument.

The discount window is the Federal Reserve facility for lending to eligible depository institutions. An institution may borrow funds for short periods from a Federal Reserve Bank to augment its reserve balances for interbank transactions. The discount rate is the interest rate charged for this short-term loan. The rate is set by each Bank subject to approval by the Board of Governors; over time, it has become common practice for the rate to be uniform for all 12 Reserve Banks. A higher rate discourages borrowing and in turn lending by banks and thrifts. The operations of the discount window are not as efficient as open market operations. Currently, the discount window serves mainly as a complement to open market operations.

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<sup>1</sup> For more information on monetary policy, see CRS Report RL30354, *Monetary Policy: Current Policy and Conditions*, by Gail Makinen and Marc Labonte.

## **Supervision and Regulation**

The Board of Governors has a broad range of supervisory and regulatory responsibilities that affect the entire U.S. banking system. The board seeks to promote safety and soundness, ensure compliance with laws and regulation, and foster the fair and efficient delivery of services to customers of financial institutions. Federal Reserve Board regulations implement policies set by Congress that are defined in legislation and referred to the Federal Reserve for enforcement. For example, the Fed has implementation and enforcement responsibilities for the Truth in Lending Act, the Electronic Funds Transfer Act, and the Fair Housing Act. The board coordinates its activities with other federal and state regulatory agencies. The board has the power to examine all member banks and their affiliates and to require periodic reports from them.

The board has the primary responsibility for supervising and regulating bank holding companies and state-chartered banks that are members of the Federal Reserve System. In addition, the board supervises corporations through which U.S. banks conduct operations abroad, and the U.S. operations of foreign banks. The board delegates many supervisory duties to the 12 Reserve Banks subject to the board's policy and oversight. An example is the task of conducting bank examinations.

The Board of Governors has broad oversight and supervisory authority over the operations and activities of the Federal Reserve Banks. The board appoints three of the nine directors of each Bank. The Board conducts annual financial examinations of the Reserve Banks. Major expenditures, such as building construction, must be approved by the board. The salaries of Reserve Bank presidents and first vice presidents are subject to board approval.

## **Federal Reserve Banks**

The 12 Federal Reserve Banks carry out the day-to-day operations of the Federal Reserve System. Within each geographic district a city was designated as the location of the Reserve Bank. The act also provided for branch offices to support the operations of the Federal Reserve Banks. The 12 Banks are located in Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco. The Board of Governors has established 25 branches over the years.

Each Federal Reserve Bank is managed by a nine-member board of directors that is divided into three classes: A, B, and C. They serve three-year terms on a staggered basis. The three Class A and Class B directors are elected by the member banks in each district. Three Class C directors are appointed by the Board of Governors. The three Class A directors represent the interests of the member banks. The remaining six directors represent the general public and are selected with due consideration to the interests of agriculture, commerce, industry, services, labor, and consumers. Class B and C directors cannot be officers, directors or employees of any banking institution. In addition, Class C directors cannot hold stock in a bank or bank holding company. The board designates one Class C director as chairman and another as deputy chairman. Each Reserve Bank is headed by a president appointed by the nine directors with the approval of the Board of Governors.

The District Banks are the principal medium through which the general supervisory powers of the Fed are executed. Federal Reserve Banks conduct on-site examinations of state member banks and inspections of bank holding companies and their nonbank subsidiaries.

The Federal Reserve Banks provide fiscal agency and depository services to the federal government. For example, as fiscal agents they issue, transfer, exchange and redeem government securities and savings bonds. As depositories, they provide transaction accounts for the Treasury and they collect and disburse funds on behalf of the federal government.

The 12 Reserve Banks provide banking services to depository financial institutions. The Banks maintain reserve and clearing accounts for banks and thrifts. The Banks play a major role in the nation's payment system. Reserve Banks move coin and currency into and out of circulation. They also participate in the collection and processing of millions of checks daily. The Banks are an integral part of electronic funds transfer systems, clearing and settling electronically originated credits and debits.

The income of the Federal Reserve Banks is primarily generated from interest on government securities acquired through open market operations. In addition, the Monetary Control Act of 1980 requires the Federal Reserve to charge fees for various services. From their earnings the Reserve Banks pay their operating and other expenses. The Banks are assessed semiannually by the Board of Governors for the board's costs and expenditures. The residual earnings are turned over to the U.S. Treasury. Payments to the Treasury in 2004 totaled \$18.1 billion.<sup>2</sup>

## Member Banks

The Federal Reserve Act requires all national banks to be members of the Federal Reserve System. National banks are banks chartered by the federal government. Membership by state-chartered banks is optional. If state-chartered banks elect to become members they must meet the standards set by the Board of Governors. As of June 30, 2004, there were 1,955 national banks and 930 state-chartered Federal Reserve member banks. While these banks represented only about 38% of all federally insured U.S. banks, they held about 79% of all insured bank assets.<sup>3</sup> The 12 Reserve Banks are "owned" by their member banks. The stock of the Federal Reserve Banks is held entirely by the member banks in their respective districts. Ownership of this stock does not carry the usual rights of control and financial interest ordinarily associated with being a shareholder in a corporation operated for the purpose of making a profit. Each member bank buys stock in its district Reserve Bank equal to 6% of its own capital and surplus. Of this amount, 3% must be paid-in and 3% is subject to call by the Board of Governors. The stock may not be sold or pledged as security for loans. Dividends are set by law at the rate of 6% per year on paid-in stock.

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<sup>2</sup> U.S. Federal Reserve System, *2004 Annual Report of the Board of Governors of the Federal Reserve System*, April 2005, p.129.

<sup>3</sup> Ibid. p.289.

## **Congressional Oversight**

Throughout the history of the Federal Reserve System, Congress has been concerned with achieving a balance between assuring independence for the System's operations and making the agency accountable for its actions. Attention to Federal Reserve accountability has resulted in increased disclosure by the Fed and dialogue between the Fed and Congress on monetary policy and the agency's operations overall. Avenues of communication and oversight, both formal and informal, have developed over time.

Aside from its appointment role, Congress exercises oversight in a variety of ways. The Federal Banking Agency Audit Act (P.L. 95-320) was enacted in 1978 to enhance congressional oversight responsibilities. The law gave the General Accounting Office (GAO; now the Government Accountability Office) the authority to audit the Board of Governors, the Reserve Banks and branches. Such audits are limited, however, as GAO is prohibited from auditing monetary policy operations, foreign transactions, and the FOMC operations. Congressional oversight on these matters is exercised through the requirement for reports and through semi-annual monetary policy hearings.

### **Reports and Hearings**

The Federal Reserve publishes numerous reports during the year which are important to the oversight work of Congress. The Board of Governors publishes an annual report of activities which includes the minutes of the FOMC meetings. The board is required by law to report annually on compliance with its consumer regulations. The Federal Reserve issues reports and surveys on a variety of subjects, for example an annual survey of bank fees and services and a report on the profitability of credit card operations.

The Fed is frequently called upon to testify on a wide range of issues affecting the economy and the banking industry. In addition, a monetary policy reporting system, accomplished through hearings, was made a matter of legislative mandate in the Federal Reserve Reform Act of 1977 (P.L. 95-188). The process was modified by provisions embodied in P.L. 95-523, the Humphrey-Hawkins Act of 1978. The provisions are designed to enhance the dialogue on monetary policy between Congress and the Federal Reserve through a more detailed reporting and evaluation process than existed earlier. Further, the provisions are intended to contribute to the ability of Congress to take a coordinated look at government economic policies. The two goals are sought through a system of regularly scheduled oversight hearings at which the Federal Reserve reports to the banking committees on its policy intention. The banking committees in turn report to their respective houses.

The statutory requirements for semi-annual monetary policy reporting, the board's annual report and several other reports would have been discontinued by provisions of the 1995 Federal Reports Elimination and Sunset Act (P.L. 104-66). Provisions contained in P.L. 106-569, enacted on December 27, 2000, reinstated these requirements.