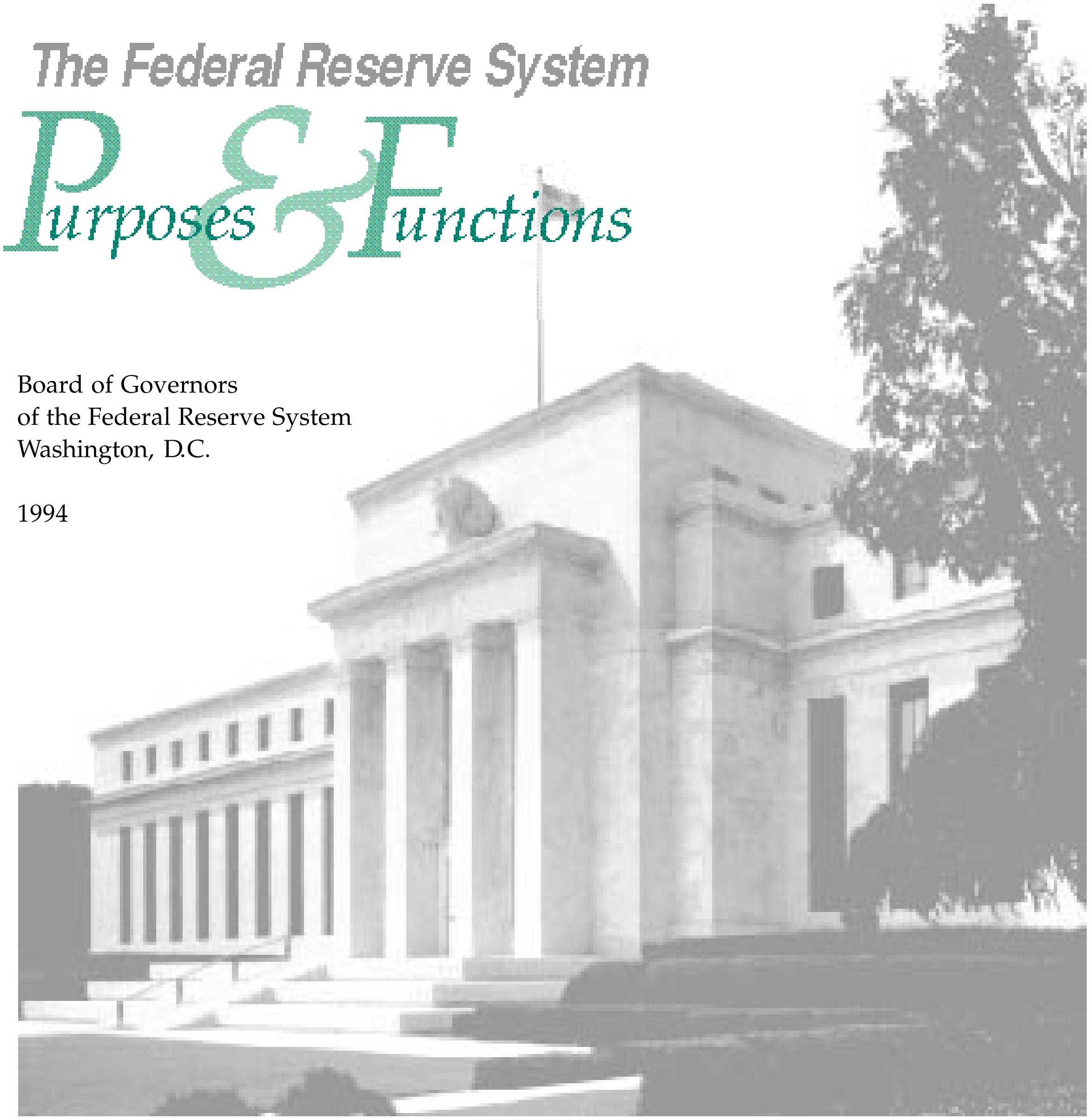
The Federal Reserve System
Purposes & Functions



Board of Governors
of the Federal Reserve System
Washington, D.C.

1994

Preface

This is the eighth edition of The Federal Reserve System: Purposes and Functions. *It has been revised by staff members of the Federal Reserve Board to reflect the changes that have taken place in the monetary, regulatory, and other policy areas since publication of the seventh edition in 1984. It incorporates major changes in the law and in the structure of the financial system that have occurred over the past decade.*

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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 money and credit conditions in the economy in pursuit of full employment and stable prices
- 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 certain financial services to the U.S. government, to the public, to financial institutions, and to 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 Bank of England has existed since the end of the seventeenth century. Napoleon I established the Banque de France in 1800, and the Bank of Canada began operations in 1935. The German central bank was reestablished after World War II and is loosely modeled on the Federal Reserve.

BACKGROUND

Before Congress created the Federal Reserve System, periodic financial panics had plagued the nation. These panics had contributed to many bank failures, business bankruptcies, and general economic downturns. A particularly severe crisis in 1907 prompted Congress to establish the National Monetary Commission, which put forth proposals to create an institution that would counter financial disruptions of these kinds. After considerable debate, Congress passed the Federal Reserve Act, which President Woodrow Wilson signed into law on December 23, 1913. The act stated that its purposes were "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."

Woodrow Wilson signed the Federal Reserve Act at 6:02 p.m. 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 1970 amendments to the Bank Holding Company Act; 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; and the Federal Deposit Insurance Corporation Improvement Act of 1991. Congress defined the primary objectives of national economic policy in two of these acts: the Employment Act of 1946 and the Full Employment and Balanced Growth Act of 1978 (the latter 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.

The Federal Reserve System is considered to be an independent central bank. It is so, however, only in the sense that its decisions do not have to be ratified by the President or anyone else in the executive branch of government. The entire System is subject to oversight by the U.S. Congress because the Constitution gives to Congress the power to coin money and set its value—a power that, in the 1913 act, Congress itself delegated to the Federal Reserve. The Federal Reserve must work within the framework of the overall objectives of economic and financial policy established by the government, and thus the description of the System as "independent within the government" is more accurate.

STRUCTURE OF THE SYSTEM

The Federal Reserve System has a structure designed by Congress 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 basically of a central, governmental agency—the Board of Governors—in Washington, D.C., and twelve regional Federal Reserve Banks, located in major cities throughout the nation. These components share responsibility for supervising and regulating certain financial institutions and activities; for providing banking services to depository institutions and to the federal government; and for ensuring that consumers receive adequate information and fair treatment in their business with the banking system.

The Federal Reserve System is composed of the Board of Governors and twelve regional Reserve Banks.

A major component of the System is the Federal Open Market Committee (FOMC), which is made up 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 money market conditions and the growth of money and credit.

Two other groups play roles in the way the Federal Reserve System works: depository institutions, through which the tools of monetary policy operate, 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 was established as a federal government agency. It is made up of seven members 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; 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 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 Washington staff numbering about 1,700. 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. It also supervises and regulates the operations of the Federal Reserve Banks and their Branches and the activities of various banking organizations, exercises broad responsibility in the nation's payments system, and administers most of the nation's laws regarding consumer credit protection.

The first Federal Reserve Board, 1914.

The Federal Reserve System conducts monetary policy using three major tools:

- Open market operations—the buying and selling of U.S. government (mainly Treasury) securities in the open market to influence the level of reserves in the depository system
- Reserve requirements—requirements regarding the amount of funds that commercial banks and other depository institutions must hold in reserve against deposits
- The discount rate—the interest rate charged commercial banks and other depository institutions when they borrow reserves from a regional Federal Reserve Bank.

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 also approve any change in the discount rate initiated by a Federal Reserve Bank.

The Federal Reserve also plays a major role in the supervision and regulation of the U.S. banking system. Banking supervision—the examination of institutions for safety and soundness and for compliance with law—is shared with the Office of the Comptroller of the Currency, which supervises national banks, and the Federal Deposit Insurance Corporation, which supervises state banks that are not members of the Federal Reserve System. The Board's supervisory responsibilities extend to the roughly 1,000 state banks that are members of the Federal Reserve System, all bank holding companies, the foreign activities of member banks, the U.S. activities of foreign banks, and Edge Act and agreement corporations (institutions that engage in a foreign banking business).

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 are automatically members of the System. The Board also issues regulations to carry out major federal laws governing consumer credit protection, such as Truth in Lending, Equal Credit Opportunity, and Home Mortgage Disclosure; many of these 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 policymakers 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. Under the Humphrey–Hawkins Act, the Board of Governors must submit a report on the economy and the conduct of monetary policy to Congress by February 20 and July 20 of each year. The Chairman of the Board of Governors is called to testify on the report before the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Banking, Finance and Urban Affairs.

The Board has regular contact with members of the President's Council of Economic Advisers and other key economic officials, and the Chairman 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, is a member of the board of the Bank for International Settlements (BIS), and is 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—the Group of Seven, or G-7. He, other Board members, and Board staff members share many international responsibilities, including representing the Federal Reserve at meetings at the BIS in Basle and at the Organisation for Economic Co-operation and Development in Paris.

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 also 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.

The Board publishes detailed statistics and other information about the System's activities and the economy in publications such as the monthly *Federal Reserve Bulletin*, special announcements of Board actions, and separate statistical releases. Through the Federal Reserve Regulatory Service, it provides materials relating to its regulatory and supervisory functions.

The Board is audited annually by a major public accounting firm, and the audit report is published in the Board's *Annual Report*. The General Accounting Office (GAO) also audits the Board. A complete list of audits or studies performed and under way by the GAO is available in the Board's annual *Budget Review*, which is sent to Congress during the first quarter of each calendar year. Monetary policy, which is exempt from audit by the GAO, is monitored directly by Congress through written reports, including the semiannual Humphrey–Hawkins reports, prepared by the Board of Governors.

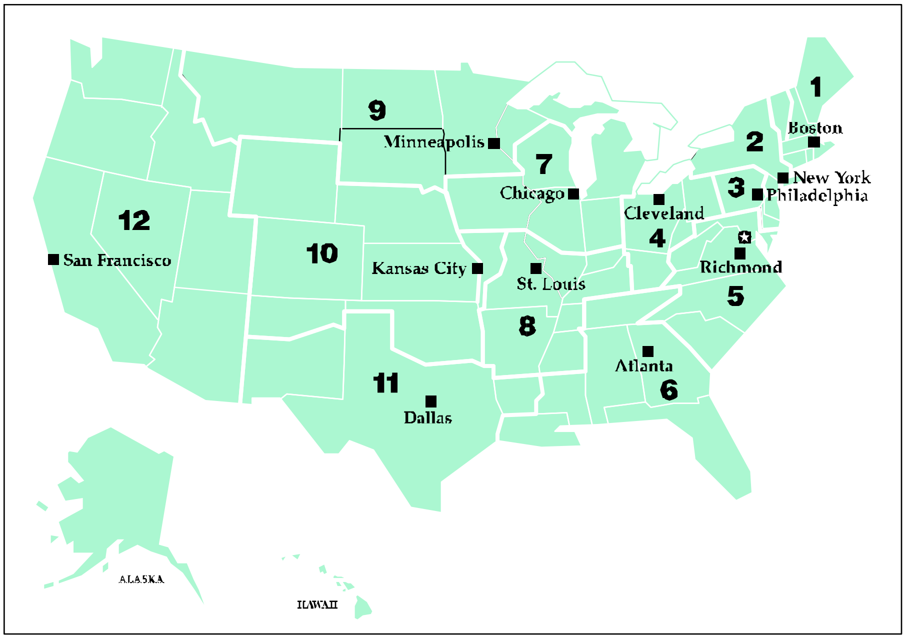
Federal Reserve Banks

A network of twelve Federal Reserve Banks and their twenty-five Branches 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. Each Reserve District is identified by a letter and a number (see list of District offices on page 10). All U.S. currency carries the letter and number designation of the Reserve Bank that first puts it into circulation. 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 offices and boundaries of the Federal Reserve Districts are shown on the maps on pages 8 and 9.

The Board of Governors exercises broad authority over 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. Other types of expenditures—

The Federal Reserve System



Legend

Both pages

■ Federal Reserve Bank city

✪ Board of Governors of the Federal Reserve System, Washington, D.C.

Facing Page

• Federal Reserve Branch city

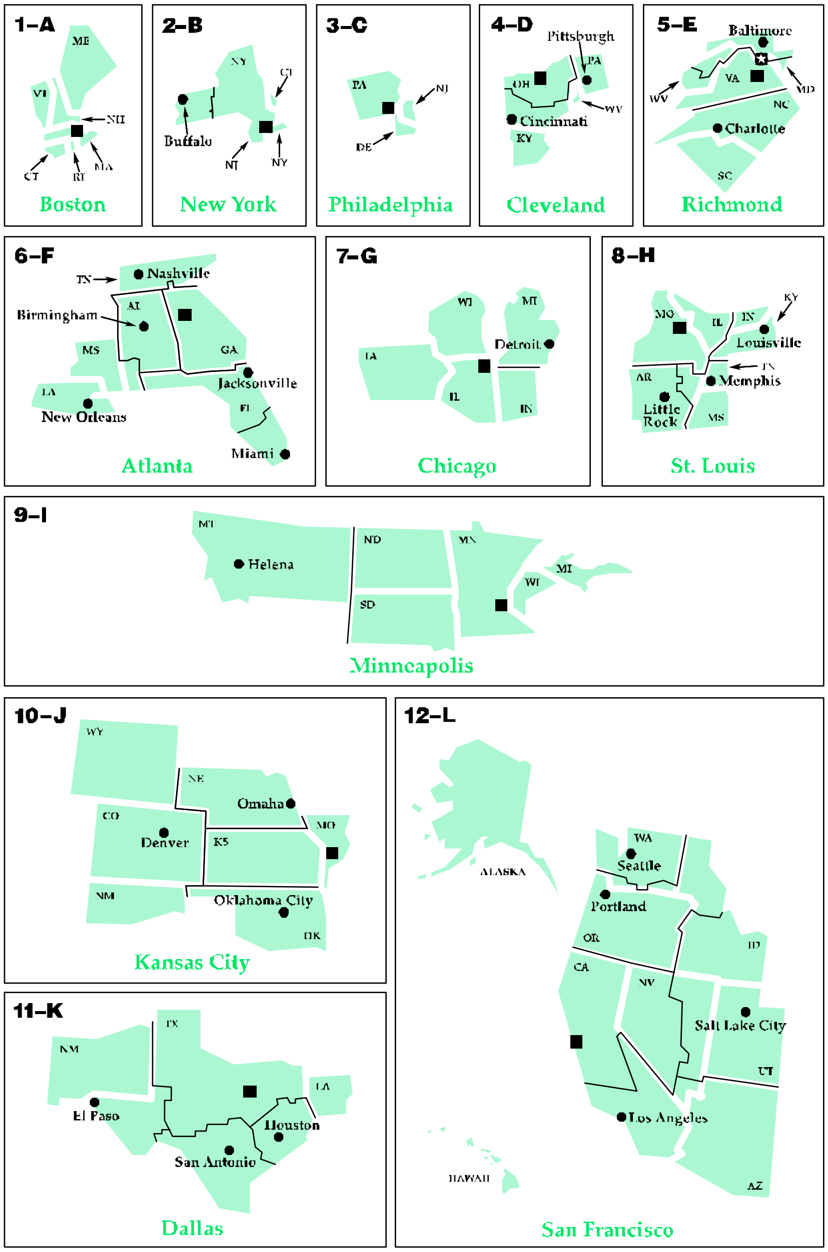
— Branch boundary

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

The System serves commonwealths and territories as follows: 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.


1–A
ME
VT
NH
CT
RI
MA
Boston
2–B
NY
CT
Buffalo
NJ
NY
New York
3–C
PA
NJ
DE
Philadelphia
4–D
Pittsburgh
PA
OH
WV
Cincinnati
KY
Cleveland
5–E
Baltimore
WV
VA
MD
NC
Charlotte
SC
Richmond
6–F
TN
Nashville
Birmingham
AL
MS
GA
LA
Jacksonville
New Orleans
FL
Miami
Atlanta
7–G
WI
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Detroit
IA
IL
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Chicago
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KY
MO
IL
IN
Louisville
TN
AR
Memphis
Little Rock
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St. Louis
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Kansas City
11–K
TX
NM
LA
El Paso
Houston
San Antonio
Dallas
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ALASKA
WA
Seattle
Portland
OR
ID
CA
NV
Salt Lake City
UT
Los Angeles
HAWAII
AZ
San Francisco

Federal Reserve District Banks and Branches[1]

Number	Letter	Bank	Branch
1	A	Boston	
2	B	New York	Buffalo, N.Y.
3	C	Philadelphia	
4	D	Cleveland	Cincinnati, Ohio Pittsburgh, Pa.
5	E	Richmond	Baltimore, Md. Charlotte, N.C.
6	F	Atlanta	Birmingham, Ala. Jacksonville, Fla. Miami, Fla. Nashville, Tenn. New Orleans, La.
7	G	Chicago	Detroit, Mich.
8	H	St. Louis	Little Rock, Ark. Louisville, Ky. Memphis, Tenn.
9	I	Minneapolis	Helena, Mont.
10	J	Kansas City	Denver, Colo. Oklahoma City, Okla. Omaha, Nebr.
11	K	Dallas	El Paso, Tex. Houston, Tex. San Antonio, Tex.
12	L	San Francisco	Los Angeles, Calif. Portland, Ore. Salt Lake City, Utah Seattle, Wash.

1. The Federal Reserve Bank of New York maintains an operations center in East Rutherford, New Jersey. Additional offices, which serve as regional check-processing centers, are located in Lewiston, Maine; Windsor Locks, Connecticut; Jericho, New York; Utica, New York; Columbus, Ohio; Columbia, South Carolina; Charleston, West Virginia; Des Moines, Iowa; Indianapolis, Indiana; and Milwaukee, Wisconsin.

such as those for construction or major alterations of Reserve Bank buildings and for the salaries of Reserve Bank presidents and first vice presidents—are also 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; and like the Board members, Reserve Bank presidents may testify before congressional committees. Each Reserve Bank has a staff of full-time officers and employees that manages and operates it.

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

Each Reserve Bank has its own board of nine directors chosen from outside the Bank as provided by law. Three directors, designated Class A, 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 in Washington, D.C., 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 of five or 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 and Branches 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 to the Board of Governors a discount rate for its Bank; a recommendation for a change cannot take effect unless the Board of Governors approves it.

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 (the rate on which is the so-called discount rate); and fees received for services provided to depository institutions, such as check clearing, funds transfers, and automated clearinghouse operations.

The FOMC is composed of the members of the Board of Governors and five Reserve Bank presidents.

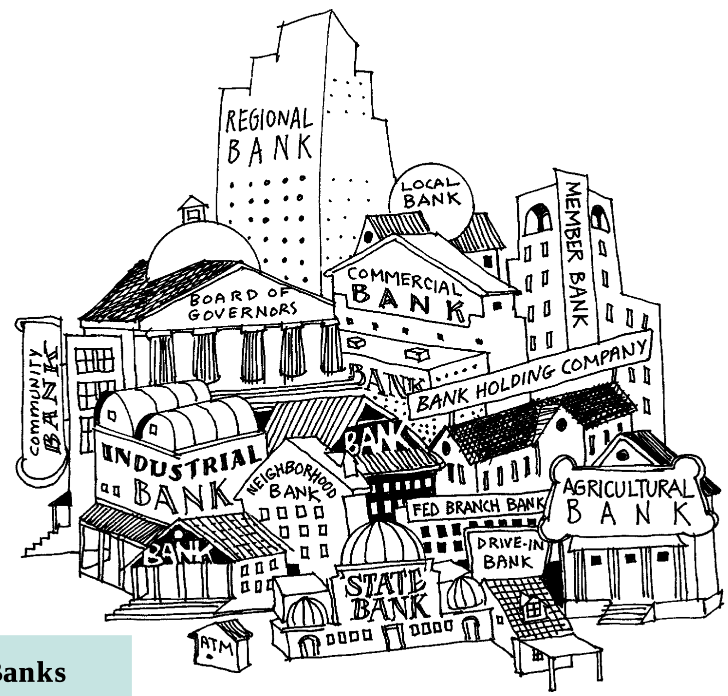
After it pays its expenses, the Federal Reserve turns the rest of its earnings over to the U.S. Treasury. About 95 percent of the Reserve Banks' net earnings have been paid into the Treasury since the Federal Reserve System began operations in 1914. (Income and expenses of the Federal Reserve Banks from 1914 to the present are included in the *Annual Report* of the Board of Governors.) If a Reserve Bank were liquidated for any reason, all proceeds after the payment of bills would also be turned over to the Treasury.

The Board of Governors audits the Reserve Banks every year, and its staff periodically reviews operations in key functional areas. 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 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 influence the amount of reserves available to depository institutions (see chapter 3). The FOMC also sets ranges for the growth of the monetary aggregates and 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.[1] 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 members of the Committee 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 are held eight times each year in Washington, D.C. Telephone consultations and other meetings are held when needed.



Member Banks

As suggested previously, the nation’s 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).

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.

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. At the end of 1993, 4,338 banks were members of the Federal Reserve System—3,360 national banks and 978 state banks—out of 11,212 commercial banks nationwide.

Member banks must subscribe to stock in their regional Federal Reserve Bank in an amount equal to 3 percent of their capital and surplus. 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 that goes along with 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. The stock is not available for purchase by individuals.

Advisory Committees

The Federal Reserve System uses advisory and working committees in carrying out its varied responsibilities. Three of these committees advise the Board of Governors directly:

- ***Federal Advisory Council.*** The Federal Reserve Act established the council, which consists of one member—traditionally a commercial banker—from each Federal Reserve District. The council is required by law to meet four times each year with the Board of Governors in Washington, D.C., to discuss economic and banking matters.
- ***Consumer Advisory Council.*** This statutory council, which has thirty members, meets with the Board three times a year on matters concerning consumers and the consumer credit protection laws administered by the Board. The council consists of academics, legal specialists in consumer matters, and members representing the interests of consumers and the financial industry.
- ***Thrift Institutions Advisory Council.*** After the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, which extended to thrift institutions the Federal Reserve's reserve requirements and access to the discount window, the Board of Governors established this council to

obtain information and opinions on the needs and problems of thrift institutions. The council is made up of representatives of savings and loan associations, savings banks, and credit unions.

The Federal Reserve Banks also use advisory committees. Perhaps the most important are the committees (one for each Reserve Bank) that advise the Banks on matters of agriculture and small business. Two representatives of each committee meet once a year in Washington, D.C., with the Board of Governors. ■