FEDERAL RESERVE SYSTEM

STRUCTURE AND FUNCTIONS

Federal Reserve Bank of Atlanta

THE FEDERAL RESERVE

Like most industrialized nations, the United States has a central bank to meet certain needs of its complex economy and financial system. Unlike most central banks, however, the United States' Federal Reserve System is, in a sense, a "decentralized" central bank. It consists of 12 regional *Federal Reserve Banks* and their branches operating under the general oversight of the *Board of Governors* of the Federal Reserve System in Washington, D.C.

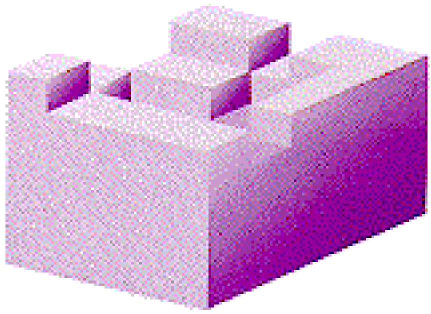
Established in December 1913 by the Federal Reserve Act, the Federal Reserve System was designed to rectify the conditions underlying the recurrent money panics that had plagued the country for many years. The act has been amended several times to further the Federal Reserve System's ability to foster a sound financial system and a healthy economy.

The Federal Reserve System advances this goal through several means. Its monetary policy decisions affect the flow of money and credit in the economy. It contributes to the safety and soundness of the national financial system by establishing regulations and acting as a commercial bank supervisor. And, by serving as a bank for depository institutions and the federal government, the Fed helps ensure that the system of paying for all kinds of business transactions works efficiently.

The Federal Reserve's Structure

To safeguard the Federal Reserve from short-term political pressures while ensuring its fundamental accountability, the System was set up to be "independent" within government. The System operates on its own earnings rather than on congressional appropriations, and the members of its *Board of Governors* are appointed for long, staggered terms, limiting the influence of day-to-day political considerations.

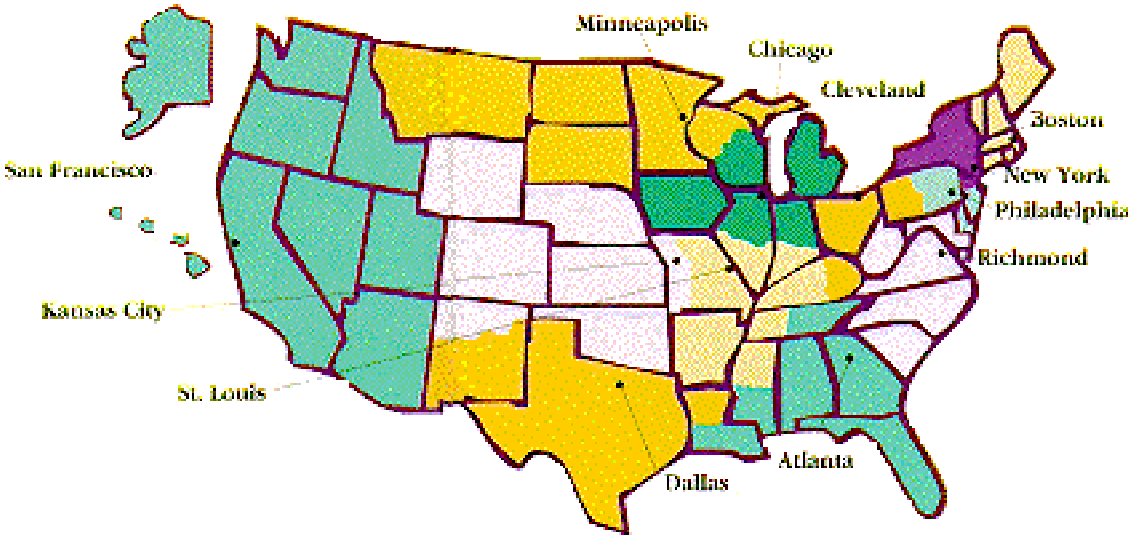
The Federal Reserve works within government, however, in the sense that it formulates monetary policy to achieve overall goals set by Congress and the President. Although the Federal Reserve's specific decisions do not have to be approved by the President or the executive branch, the System must report to Congress, which created it. Congress has the power to alter or even abolish the System at any time.



The unique structure of the Federal Reserve System also provides internal checks and balances ensuring that its decisions and operations are not dominated by any one System component. The boxes that follow outline these components and their functions.

The Board of Governors

- Is located in Washington, D.C.
- Consists of seven members appointed by the President and confirmed by the Senate for staggered 14-year terms; the chairman and vice chairman are designated by the President, with Senate approval, for four-year terms (renewable during their Board-member terms).
- Reports to Congress, including an annual report on operations and semi-annual reports on the state of the economy and the System's objectives for the growth of money and credit. The chairman meets regularly with the President and the Secretary of the Treasury; members testify frequently before congressional committees.
- Sets reserve requirements for depository institutions and approves discount rate changes proposed by *Reserve Bank* directors.
- Establishes and administers financial safety and soundness and consumer protective regulations; administers regulations regarding bank consolidation.
- Oversees *Reserve Banks'* services to depository institutions, bank supervision functions, and accounting procedures; approves Reserve Banks' budgets.



Federal Reserve Banks

- Are located in Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco; branches are located in 25 other cities.
- Are each separately incorporated, with a board of nine directors. Directors, under *Board of Governors* supervision, oversee their Bank's operations and appoint and recommend salaries of the Bank's president and first vice president.
    - Six directors—three class A, representing the banking industry, and three class B—are elected by member banks (including all nationally chartered banks and state-chartered banks that meet certain requirements); three class C directors (including the chairman and deputy chairman) are appointed by the *Board of Governors*. Class B and C directors represent agriculture, commerce, industry, labor, and services in the District; they cannot be officers, directors, or employees of a bank; class C directors cannot be bank stockholders.
    - Branch bank's boards have five or seven directors; the majority are appointed by head-office directors and the rest by the *Board of Governors*.
- Monitor national and international economic conditions and provide information on their Districts that the System needs to formulate monetary policy.
- Hold reserve balances for and serve as "lender of last resort" to depository institutions; directors establish the discount rate charged on such loans, subject to approval by the *Board of Governors*.
- Examine and supervise certain types of depository institutions.
- Provide financial services to depository institutions and the U.S. Treasury.

- Turn over to the U.S. Treasury earnings in excess of the amount needed to pay expenses and dividends to member banks, maintain a surplus equal to its paid-in capital, and pay operating expenses.

Federal Open Market Committee (FOMC)

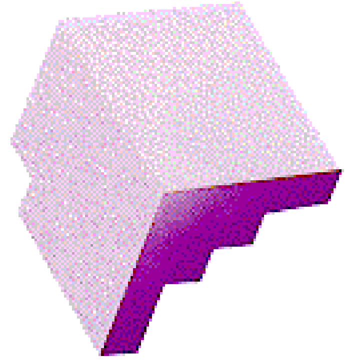
- Meets in Washington, D.C., eight times a year.
- Comprises 12 members—the seven members of the *Board of Governors* and five *Reserve Bank* presidents, one of whom is the president of the Federal Reserve Bank of New York; other presidents serve one-year terms on a rotating basis; all participate in each meeting.
- Directs open market operations, the most important instrument of monetary policy.

Advisory Committees

- Advise the System and provide information on various groups affected by System policies.
  - The Federal Advisory Council confers with the *Board of Governors* at least four times a year on economic and banking issues.
  - The Consumer Advisory Council represents consumers and institutions that finance them.
  - The Thrift Institutions Advisory Council provides information and views on the special needs and problems of thrift institutions.
- Advise individual *Reserve Banks* on these and other interests at the regional level.

The Federal Reserve's Functions

As the U.S. central bank, the Federal Reserve carries out a number of functions that affect the nation's economic well-being. Through monetary policy, which influences the availability of money and credit, the Federal Reserve plays a major role in keeping inflation in check while promoting economic growth. By supervising and regulating commercial banks, the Fed fosters the U.S. financial system's safety and soundness. Finally, the Fed helps make commercial transactions more efficient by providing check-clearing and other payments services to depository institutions and the federal government.



Monetary Policy

Aside from market dynamics like consumer spending patterns and business investment decisions, a major influence on a country's economic performance is public policy—monetary policy and fiscal policy. Monetary policy is carried out by the Federal Reserve. Fiscal policy is determined by the legislative and executive branches of the U.S. government chiefly through decisions about taxation and spending.

The objectives of the nation's economic policy are to protect the purchasing power of the U.S. dollar, encourage conditions favorable to sustainable economic growth and a high level of employment, and foster a reasonable balance in transactions with other nations over the long run. The Federal Reserve System contributes to these objectives through its monetary policy actions affecting the availability and cost of money and credit.

The Federal Reserve, seeking to adjust monetary policy to changing economic conditions, bases its policy decisions on current economic and financial information. For example, the *Federal Open Market Committee's* policy actions are influenced at least in part by the economic analysis provided by staff economists and analysts at the *Reserve Banks* and the *Board of Governors*. Each component of the System—the Reserve Banks, the Board of Governors, and the FOMC—plays various roles in formulating and carrying out the System's monetary policy.

Tools of Monetary Policy

To foster economic growth while maintaining price stability, the Federal Reserve must balance the flow of money and credit with the needs of the economy. The *Reserve Banks*, the *Board of Governors*, and the *FOMC* achieve this balance by influencing the levels of financial institutions' reserves, which in turn affect the institutions' ability to make loans or purchase investments. These reserves, required by law of all U.S. depository institutions, must be equal to specified percentages of the institutions' deposits and can be held either in the form of cash on hand or account balances at *Reserve Banks*.

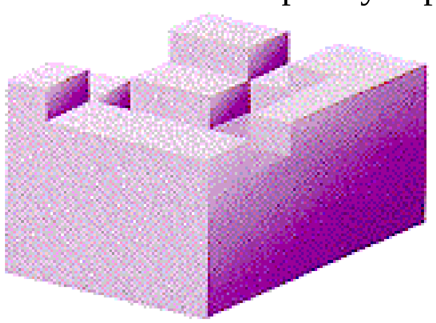
The Fed has three policy tools for influencing reserves: (1) open market operations, (2) the discount rate, and (3) reserve requirements.

Open market operations. The most flexible, and therefore most important, of the Fed's monetary policy tools is open market operations—the purchase and sale of government securities in the open market. The Fed's open market operations are directed by the *FOMC* and carried out through the trading desk of the Federal Reserve Bank of New York.

To increase the availability of money and credit, the Fed buys government securities. Purchases of such securities are paid for by crediting the reserve accounts (held at *Federal Reserve Banks*) of the depository institutions handling the securities dealers' transactions. These larger reserve accounts give the banks more money for lending and investing elsewhere.

To tighten money and credit flows the Fed sells securities, thereby restraining the growth in banks' reserve balances and restricting their lending and investing activities.

The discount rate. Depository institutions sometimes borrow money from *Reserve Banks* to cover temporary deposit drains. The discount rate, the rate of interest charged on these short-term, "discount window" loans, is set by *Reserve Banks'* boards of directors, subject to approval by the *Board of Governors*. A change in the discount rate can either inhibit or encourage financial institutions' lending and investment activities by making it more or less expensive for them to obtain funds. Although the discount rate may have little direct effect on market conditions, a change in the discount rate can be an important signal of the Fed's policy direction.



Reserve requirements. Within limits prescribed by law, the *Board of Governors* can change the percentage of deposits that depository institutions must set aside as reserves. The Federal Reserve changes reserve requirements much less often than it does the discount rate because such changes have a farther-reaching impact on the financial industry.

Supervision of Banks

Commercial banks are governed by a variety of regulations intended to ensure that they serve their depositors and communities well and are operated in accordance with sound banking principles.

Several federal and state agencies share the responsibility for writing these regulations and for examining banks to determine their compliance. The Federal Reserve takes part in writing regulations. It supervises all bank holding companies as well as state-chartered banks that are members of the Federal Reserve System. The Fed also regulates foreign activities of all U.S. banks and certain U.S. activities of foreign banks.

Bank holding companies and certain banks that wish to acquire or merge with other banks must get prior Federal Reserve approval. Staff at a *Reserve Bank* analyze the banks and financial markets that will be affected by a proposed merger or acquisition, taking into account the convenience and needs of the community to be served and the financial and managerial resources of the existing and proposed institutions. The *Board of Governors* approves or disapproves merger and acquisition applications based on Reserve Banks' findings and recommendations.

In addition, *Reserve Banks* monitor commercial banks' compliance with consumer protection laws relating to credit, such as the Truth in Lending Act. Reserve Bank specialists help banks interpret technical requirements of the laws. They also provide information and assistance to consumers with questions or complaints regarding commercial banks' services.

Discount Window Loans

Reserve Banks also help maintain a sound banking system by acting as the "lender of last resort" for depository institutions. Institutions that find themselves temporarily short of reserves because of unexpected credit demands, deposit drains, or seasonal economic factors may be eligible to borrow from a Reserve Bank. The availability of credit from the Federal Reserve is intended to stabilize individual depository institutions, as well as the banking and financial system as a whole, during times of liquidity stress. Depository institutions are expected to seek funds first from reasonably available alternative sources, relying on the Federal Reserve discount window only in exceptional circumstances.

Generally, discount window loans are made for a day or two to help the borrowers adjust their reserve position. Discount window credit is subject to governing statutes and is administered according to Systemwide policy guidelines, subject to the judgment of lending officers at the individual *Reserve Banks.*

Services to Depository Institutions

As part of the nation's central bank, *Reserve Banks* are actively involved in the nation's payments system to help it operate as efficiently and safely as possible. Unlike private providers of payments services, Federal Reserve Banks do not offer these services to make a profit—their service fees must closely match and not exceed their costs.

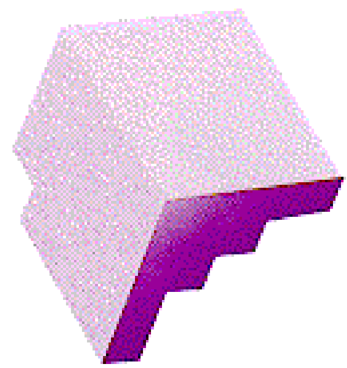
Since the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, *Reserve Banks'* financial services have been available not just to banks that are members of the Federal Reserve System but also to nonmember commercial banks, savings and loan associations, credit unions, and mutual savings banks.

In some ways Federal Reserve Banks' services to depository institutions are similar to depository institutions' services to their customers—transferring funds, providing cash, and accepting and safeguarding deposits.

Payments System Services

Most of the nation's spending money is held in some form of checking account. Although checks are the most common means of paying for transactions, electronic transfers are gaining in use.

Check collection. Frequently a check is cashed or deposited at a depository institution far from the institution on which it is drawn. Over a third of such checks are collected through the Federal Reserve Banks' check collection system. (Another large portion is handled within banking organizations or their correspondent banks. The remainder are processed by commercial banks or other private-sector check-processors.) High-speed, computer-controlled machines at Reserve Banks sort checks, total the amounts, credit the depositing institution, and charge the institution on which they are drawn. The checks are then sent to the latter depository institution.



Electronic transfers. Electronic Funds Transfer (EFT) and Automated Clearinghouse (ACH) are terms that relate to computerized transfers of funds. Unlike a check—which may travel thousands of miles in several days and be processed many times—an electronic transfer can do the same job in seconds by computer, with no paper to mail. The Reserve Banks' computer-based communications network makes these operations possible.

Cash services. Although checks and electronic fund transfers account for most of the dollar volume of spending, cash is still an important medium of exchange.

New coins and notes are shipped from the U.S. Treasury to the Federal Reserve Banks, where the cash is stored until needed to fill orders from depository institutions. Depository institutions, of course, furnish cash to businesses and the public.

When depository institutions have excess cash on hand they may return it to the Reserve Banks, where the amount is verified and worn-out notes are destroyed. Counterfeits are removed and sent to the Secret Service. Worn, bent, and foreign coins, too, are culled. Reusable coins and notes are stored until needed. When depository institutions order cash, the Reserve Banks fill the orders from their stocks of new and used coins and notes.

Safekeeping and Transfer of Securities

Depository institutions may request a Reserve Bank to hold securities either for safekeeping or as collateral for loans from the Federal Reserve. U.S. government securities are usually held in book-entry (computer record) form only while other types may be held in paper form. Reserve Banks also perform such services as transferring securities between accounts, delivering coupons, and processing associated payments.

Services to the U.S. Treasury

R*eserve Banks* provide a number of banking and financial services to the U.S. Treasury, including two major services.

The Treasury's Checking Account

Incoming federal government revenues are credited to the U.S. Treasury's accounts at Reserve Banks. Most of these revenues come from transfers of funds from depository institutions in which the Treasury initially deposited its receipts from taxes and the sale of securities. The transfers are accomplished by debiting the depository institutions' reserve balance with the Federal Reserve and crediting the Treasury's account with the Fed. The Treasury spends these funds primarily by issuing checks or ACH entries, such as Social Security and armed services payroll checks or EFT payments. These checks or entries are submitted for collection to Reserve Banks, where they are charged against the Treasury's account.

The Treasury's Fiscal Agent

When its current expenses run ahead of its current cash resources, the Treasury borrows, mostly by auctioning government securities to investors. The auctions are held by the Federal Reserve Banks, acting as the Treasury's fiscal (financial) agents. The Reserve Banks also inscribe and deliver U.S. Savings Bonds sold through depository institutions and other issuing agents.

Conclusion

Like the federal government, the Federal Reserve System was designed to be a compromise between national and regional powers. Its regional base—the 12 Reserve Banks—makes the System more flexible and innovative and ensures that its decisions and actions are broadly based. The Board of Governors, acting as general overseer of the Reserve Banks, helps coordinate the System's operations. And the System's most important function—formulating and implementing monetary policy—is carried out in light of both regional and national concerns by the FOMC, the Reserve Banks, and the Board of Governors.

The Federal Reserve's major functions account for its structure and for its unique position in the federal government. Accountable to the government but working independently within it, the System is able to pursue its monetary policy goals without undue pressures from short-term political considerations.

Since its founding in 1913, the Federal Reserve System has evolved to meet the needs of a changing financial system and a growing economy. Its unique structure, however, remains its most outstanding feature and its greatest strength.

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