

The Role of Federal Reserve Banks in the Federal Reserve System

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I'm very pleased to be with you today to discuss the role of the Federal Reserve banks in the Federal Reserve System. The Federal Reserve Banks are evolving, along with the rest of the financial system. As with other financial institutions, evolution is driven by major developments in technology, globalization, terrorism risks and legislation.

I'll discuss some of the details of financial evolution, but will first take up a topic that is rarely discussed, and one I feel passionate about. The Federal Reserve System has a mixed public-private structure. However, the most important of the Fed's responsibilities have to be managed from a public-interest perspective and not from a profit-making perspective. Although the Fed has public responsibilities, that does not mean that Fed operations all have to be managed and conducted from Washington. Indeed, I'll be making the argument that the Fed's mixed public-private governance structure has been highly effective in serving the public interest precisely because not everything is run by a federal agency. The 12 regional Reserve Banks play a key role in the Federal Reserve and have a lot to do with the System's fine record of performance.

Before proceeding, I want to emphasize that the views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. I thank my colleagues at the Federal Reserve Bank of St. Louis for their comments. Alan J. Stamborski provided special assistance. However, I retain full responsibility for errors.

RESPONSIBILITIES AND GOVERNANCE OF THE FEDERAL RESERVE SYSTEM

Monetary policy is the most visible of the Fed's responsibilities. As the nation's central bank, the Federal Reserve regulates the creation of money and of liquidity more generally. The Federal Open Market Committee (FOMC) is the Fed's monetary-policy body; it consists of the seven members of the Board of Governors and the 12 Reserve Bank presidents, five of whom are voting members at any given time.

The Fed implements its monetary policy by setting a target federal funds interest rate. The primary goal of policy is to maintain an inflation rate that is low and stable—price stability. Price stability in turn creates an economic environment that fosters maximum sustainable economic growth and sustained high employment. In an environment of price stability, the Fed can respond flexibly to economic disturbances—an excellent example is 9/11—that might otherwise lead to recession. Not all recessions can be avoided, but price stability does seem to have contributed to a more stable economy over the past decade or so.

The Fed's second important responsibility is to regulate and supervise various kinds of financial institutions. These include state-chartered banks that have chosen to become Fed member banks, all bank-holding companies and all international banks that operate in the United States. The Fed's mission in this regard is to ensure a

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safe and sound, as well as competitive, banking system in this country.

A third important responsibility is provision of financial services to depository institutions and the federal government. The Fed is the Bank for bankers. The Fed circulates currency, clears checks and provides several forms of electronic payment. The Fed lends funds to banks through its discount window. This work isn't ordinarily the stuff of headlines except in dramatic cases such as the 9/11 terrorist attacks, when the Fed nipped in the bud the potential for a liquidity crisis. The Fed lent huge sums to banks financially stressed by the breakdown in the payments system and closure of normal market trading. No purely private firm would have the resources to provide emergency assistance on such a grand scale. The Fed's response to 9/11 provides an excellent example of how we work with the private sector to protect the normal functioning of private markets.

As the Bank to the U.S. government, the Fed processes government checks, money orders and savings bonds, and collects a significant portion of federal tax deposits. The Fed provides software and other services that permit the Treasury to manage its funds efficiently.

As this overview indicates, the Federal Reserve Banks, with oversight by the Federal Reserve Board of Governors in Washington, have a mix of public and private responsibilities. Monetary policy and bank regulation are clearly public responsibilities. Financial services to the banks and the Treasury have mixed public-private aspects, particularly given that a number of purely private firms compete with the Fed.

At the center of the Federal Reserve System is the Board of Governors. Members of the Board are appointed by the President of the United States with the advice and consent of the Senate for terms of office of 14 years. The Board is headquartered in Washington, is a federal agency and is clearly politically accountable. However, the structure of the System is designed to keep the Fed independent of partisan politics. The Board of Governors is not funded by annual appropriations from Congress; rather, the Board is funded

by the 12 quasi-private Reserve Banks from income on the portfolio of government securities used to conduct market transactions. Therefore, the Fed's budget isn't directly controlled by the legislative arm of government.

While the Board of Governors is a federal agency, each Reserve Bank is a corporation, with a charter granted by the federal government under the Federal Reserve Act. Each Reserve Bank has its own board of directors and its own stockholders, who are the member banks. After covering expenses and a statutory 6 percent dividend paid to the member banks on the capital they provide, the Federal Reserve Banks return their profits to the U.S. government.

Reserve Bank directors are leading citizens active in the Bank's Federal Reserve district. Each board has nine members, six elected by the member banks in the district and three appointed by the Board of Governors. Reserve Bank presidents are appointed by the boards of directors with the approval of the Board of Governors. All directors and officers are explicitly nonpolitical—they cannot hold elective office or participate actively in partisan political campaigns as, for example, campaign managers or fundraisers for candidates. Thus, the top leadership of the Reserve Banks is removed from politics, further contributing to the Fed's independence.

The Federal Reserve Banks, then, are the quasi-private part of the Federal Reserve System. The Banks draw on private sector knowledge and expertise in pursuing the Fed's mission. The structure of the boards and oversight from the Board of Governors ensure that private sector representation will serve public purposes. The System is politically accountable but separated from day-to-day political pressures. This structure serves public purposes more efficiently and effectively than would a purely federal agency.

That private-sector influence is also important in the Fed's analysis of the economy and monetary policymaking. Each Federal Reserve District not only serves the people within its geographical borders but also brings regional perspectives and information to bear on national issues. It is important to distinguish regional perspectives

from regional interests. Today, the Fed's regional structure does not serve regional interests per se but instead brings information and regional perspectives to bear on national responsibilities. Because the United States is a fully integrated national economy, monetary policy decisions affect the entire country and there is no possibility of conducting separate regional monetary policies. I believe that it is critical to the Fed's success that monetary policy decisions are a consensus outcome reflecting views from Washington—the Governors—and from around the country—the Reserve Bank presidents.

The Fed System opened its doors in 1914, or 125 years after the U.S. Constitution became the law of the land. You might think that every country would have a central bank from day one, and Congress did charter the First Bank of the United States in 1791. But banking was a controversial subject in the early days; Thomas Jefferson, for example, argued against chartering the bank, saying the Constitution did not empower Congress to create a central bank.

Congress refused to renew The First Bank's charter after 20 years because of the public outcry over its concentration of money and power. But the need for a central bank did not disappear, and a few years later Congress chartered the Second Bank of the United States. It was even larger than the first and, hence, more powerful. Again, there was opposition from some well-known leaders, including President Andrew Jackson. His attacks on the Bank's power struck a popular chord with farmers, small businesses, small banks and many politicians; all of them perceived the Bank to be a giant obstacle in their path to success. The Bank was shut down when its charter expired in 1836. Between 1836 and 1914, when the Federal Reserve began its operations, the United States struggled with an unsatisfactory banking system lacking in central authority and direction.

An important difference between the Federal Reserve today and the First and Second Banks was the perceived political links of the earlier Banks. In the minds of many, the early Banks were seen as a political arm of the powerful peo-

ple in the federal government. You don't often hear such comments today, and with good reason. As I've emphasized, the Federal Reserve System was set up to be independent of day-to-day pressures from the federal government, but to be clearly accountable to Congress. The governance structure of the Federal Reserve, designed to keep the Fed out of politics, has been successful in doing so and has contributed importantly to sound monetary policy.

FINANCIAL EVOLUTION

With rapid change in the nation's and world's financial system, the Federal Reserve has had to change, too. The Fed's public-private structure has helped the institution to adapt and change successfully.

Here are just three among many changes in the Federal Reserve System that you might not be aware of:

- The Reserve Banks are becoming a network of specialists, just as many others in corporate America are doing. In the days before computers and interstate banking, each of the 12 Federal Reserve Banks around the country provided almost all services and products to the commercial banks in its district. While some products were similar, many services and their prices varied by district. With today's nationwide and large regional banks, differences in Fed services and procedures cause problems for the many commercial banks that operate across Federal Reserve District boundaries. Thus, Reserve Banks have largely standardized their offerings. At the same time, Reserve Banks are carving out specialties so that, together, they can gain efficiencies. Certain Reserve Banks are responsible for developing and delivering particular products and services. Others are marketing them. One of the St. Louis Fed's specialties, for example, is to develop new software applications for the U.S. Treasury, which is increasing

its use of electronic receipts and payments to reduce costs and improve services.

- The Fed is cutting by more than half the number of Reserve Bank sites around the country that process checks. The Fed is contracting its paper-processing facilities because people are writing fewer checks in favor of using credit cards, debit cards and other forms of electronic payment. Check-processing has been a huge business for the Fed, which has traditionally processed about one-third of all checks written in this country. The Fed has been encouraging this transition because an electronic payments system is cheaper, more reliable and more secure than a paper-based one. All of these benefits are important to the Fed because a safe and efficient payments system is one of the Fed's key responsibilities.
- A third major change involves the increasingly open and public way the Fed conducts monetary policy. The FOMC is not the secretive group it once was. Not until 1994 did the FOMC release a press statement following a policy action. The markets employed a small army of Fed watchers to determine whether the Fed's open market operations indicated a change in the committee's policy stance. Today, the FOMC is quite open with its actions. Policy decisions are announced shortly after they are made, at a standard 2:15 p.m. Eastern time after the FOMC meeting concludes. At that time, the committee also issues a policy statement that outlines the rationale for the policy decision. Fed officials speak to the general public and testify before Congress often about the reasons for policy decisions in an effort to help people understand the role of the Fed and why it does what it does. As a result of this transparency, the markets are more in synch with FOMC decisions; the best evidence of this fact is the enormous decline in market volatility when FOMC policy decisions become known compared to the earlier era.

Now, let's move on to some of the more specific changes that are occurring in the Fed's three main areas of work.

In supervision and regulation, technology is changing the practice of bank examination. The Fed used to rely on examiner on-site visits to banks to make sure that loans were properly documented, that banks had lined up enough sound collateral before issuing loans, that there was no red-lining going on, and so forth. Today, examiners still make those visits, but much of the monitoring of the books is handled off-site, thanks to computerized information systems. And the examiners are much more forward-looking. They go beyond the record-keeping of current and past performance to look for problems that might be on the horizon so that they can be headed off. Examiners are looking ahead by focusing on risk management—such things as internal risk controls and portfolio concentrations.

Adding to the challenge is the ever-increasing size and sophistication of major banks today. The largest banks now have revenue that dwarfs the GDP of some countries.

Obviously, being a bank examiner is more challenging today than it was even 10 or 20 years ago. As banking becomes increasingly complicated, bank examiners must keep up through extensive training and specialization. Already, Fed examiners increasingly specialize in particular aspects of overseeing large, complex banking organizations.

Moreover, because there are three primary federal banking regulators—besides the Fed, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation—the Fed needs to work cooperatively with other agencies. Some regulatory issues also involve the Office of Thrift Supervision, the Securities and Exchange Commission and the Commodities Futures Trading Commission. The Fed also coordinates its bank examinations with state banking commissions. Clearly, the task of banking supervision and regulation involves multiple levels of complexity. The Reserve Banks' regional presence and extensive contacts with state regulators and the private sector, including the banking industry,

strengthen supervision by encouraging communication that might not otherwise exist.

Similarly, dramatic changes are taking place in another area of Fed responsibility—financial services to banks. The Fed does still fly and truck boxes of checks all over the country to settle accounts. But the Fed is also encouraging banks to transport digital images of checks along fiber optic networks. This innovation was made possible by the Check Clearing for the 21st Century Act, better known as Check 21. Congress enacted this legislation in 2003 with the support of the Fed. The new technology permitted by Check 21 speeds up funds settlements while reducing processing costs and boosting security.

The Fed is also keeping tabs on other developments in electronic forms of payment, such as smart cards and debit cards. The Fed has helped pioneer some electronic payments systems itself, such as the automated clearing house. But the Fed's main role in this regard should be overseeing standards for these new products to ensure that the payments system is reliable and accessible to all.

Another change in financial services involves using subcontractors in the handling of currency. When the St. Louis Fed shut down its check-processing operations in Little Rock and Louisville, the Bank decided that it no longer made sense to provide currency services the old way. It wasn't economical to maintain large buildings and staff primarily for storing and circulating currency for local commercial banks. The solution was to outsource this service through cash depots set up by armored carriers. This arrangement, though painful for our employees who have lost their jobs, has served our customers well and is creating substantial savings for taxpayers. And, I'm proud to say, other Reserve Banks are following the St. Louis Fed model in establishing cash depots.

Monetary policy is another area of innovation. Almost all press coverage of monetary policy focuses on the most recent policy decision and speculation about future policy decisions. Such discussion has been a staple of press coverage for decades.

Fed innovation has strengthened monetary policy decisionmaking. The Fed's large staff of professional economists at the Board of Governors and the Reserve Banks has made important strides in economic modeling and policy analysis. Another aspect of policy practice today is that the Fed gathers much information beyond the standard statistical releases, which report such important data as monthly employment and unemployment. One part of this process is quite formal, and it yields the Beige Book, published shortly before every FOMC meeting. The Beige Book is a collection of anecdotal information gathered by Fed economists in each district over the weeks prior to an FOMC meeting. Economists call a long list of companies to ask about what is happening in their markets and how their markets might change in the near future. These nuggets of information are summarized and made available to both FOMC members and the general public. Confidential information from individual firms is not disclosed; this practice assures Beige Book contacts that they can speak candidly.

I, along with other Reserve Bank presidents, also make calls to business leaders shortly before every FOMC meeting. The St. Louis Fed and other Fed Banks have meetings with diverse groups throughout the year to add to the store of insights.

Because anecdotal information can be so helpful, the Fed is putting more effort into gathering it. At the St. Louis Fed, we've created what we call our Branching Out initiative. We have transformed our Branches from purely operating units to the much broader role of providing a more visible intellectual presence in our branch cities. We added community affairs staff and economic education staff to each Branch to boost public understanding of monetary policy and of the economy in general. We work with high schools on economic education and many groups in our communities on financial literacy so that people will be better able to handle their financial affairs without, for example, falling prey to predatory lenders. We send our economists around the Eighth District to make public presentations, and

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we offer more programs about more topics for more people than ever before.

Our effort stems from our recognition that we need a strong base of local information and local understanding of the economy. We need local insight into who's hiring, who's firing, who's investing in new equipment and buildings, whether home sales are going up or down, whether local businesses are expanding and much more. I use this information in thinking about my role as a member of the FOMC.

As for the FOMC meetings themselves, the mystique created by the media is a tad overblown. The responsibility is great, the surroundings are intimidating—we meet in a 56-foot-long boardroom with a half-ton chandelier hanging over our heads. The brainpower assembled in the room is impressive. But, other than the real-time anecdotal information we've collected, we have very little information that anyone else couldn't gather. If you read the minutes of the meetings, and especially if you read the verbatim meeting transcript that is released with a five-year lag, you will see we aren't all on the same page all the time. We debate. We discuss the data. We listen to one another's anecdotes about how the economy is doing. We even chuckle over amusing quips. Then, after reviewing expert staff analysis and all the information and wisdom we can muster, we reach a consensus monetary policy decision. The Fed chairman, of course, leads the discussion and defines the consensus, but when any of us believes sufficiently strongly that another policy course would be better, we enter a dissent. And when the FOMC meeting is over, we adjourn and have a lunch of soup, cold cuts and salads, just as we are about to do today.

But, before we eat, I'd be delighted to take a few questions. I will ask you, however, to confine your questions to the subject matter of the speech. The FOMC has a long-standing practice of not discussing monetary policy and related issues the week before and the week of an FOMC meeting. So, while after a speech I ordinarily take questions on any and all subjects, today is different because we had an FOMC meeting only two days ago.