In Plain English: Making Sense of the Federal Reserve

Introduction

Hi, I'm Buck, your personal tour guide to the Federal Reserve. I'm here to introduce you to one of the most complex but effective institutions in the United States. But don't worry—I'll explain it all ... *In Plain English: Making Sense of the Federal Reserve*.

History and Purpose of the Fed

Before the Federal Reserve was founded, the nation was plagued with financial crises. At times, these crises led to "panics" in which people raced to their banks to withdraw their deposits. The failure of one bank often had a domino effect, in which customers of other banks rushed to withdraw funds from their own banks even if those banks were not in danger of failing. Banks needed a source of emergency reserves to prevent the panics and resulting runs from driving them out of business.

A particularly severe panic in 1907 resulted in bank runs that wreaked havoc on the fragile banking system and ultimately led Congress in 1913 to write the Federal Reserve Act. The Federal Reserve System, initially created to address these banking panics, is now charged with several broader responsibilities, including fostering a sound banking system and a healthy economy.

Although the need for banking reform was undisputed, for decades early supporters debated the delicate balance between national and regional interests. Nationally, the central bank had to make it easier to conduct financial transactions between businesses and individuals across regions of the country.

A stable central bank would also strengthen the United States' standing in the world economy because foreign individuals, businesses, and governments have confidence in doing business within a country that has a responsible central bank and economic system. Regionally, the central bank would have to respond to the local needs for currency, which could vary across regions. A lack of available currency had caused the earlier banking panics.

Another important issue was creating a balance between the private interests of banks and the centralized responsibility of government. What emerged—the Federal Reserve System—was a central bank under public control, with many checks and balances.

Congress oversees the entire Federal Reserve System. And the Fed must work within the objectives established by Congress. Yet Congress gave the Federal Reserve the autonomy to carry out its responsibilities without political pressure. Each of the Fed's three parts—the Board of Governors, the regional Reserve Banks, and the Federal Open Market Committee (FOMC)—operates independently of the federal government to carry out the Fed's core responsibilities.

The Federal Reserve System was developed and continues to develop as an interesting blend of public and private interests and centralized and decentralized decision-making. As you continue reading, you will learn about the Fed's structure and responsibilities—what the Fed is and what it does.

The **"central bank"** is the generic name given to a country's primary monetary authority. A nation's central bank is usually given a mix of responsibilities, including determining the money supply, supervising banks, providing banking services for the government, and lending to banks during crises.

Introduction to the Board of Governors

At the core of the Federal Reserve System is the Board of Governors, or Federal Reserve Board. The Board of Governors, located in Washington, D.C., is a federal government agency that is the Fed's centralized component. The Board consists of seven members who are appointed by the president of the United States and confirmed by the Senate. These Governors guide the Federal Reserve's policy actions.

A Governor's term is 14 years. It is possible, however, for a Federal Reserve Governor to serve a longer term. For example, William McChesney Martin Jr. served as a member and Chairman of the Board of Governors for nearly 19 years because he was appointed as Chairman to complete another person's term and was then appointed to his own term.

Appointments to the Board of Governors are staggered—one Governor's term expires every two years. Terms are staggered to provide the Fed political independence as a central bank, ensuring that one president cannot take advantage of his power to appoint Governors by "stacking the deck" with those who favor his policies. The Board of Governors must be nonpartisan and act independently. In addition to independence, the staggered terms enable stability and continuity on the Board of Governors. The seven Governors, along with a host of economists and support staff, write the policies that ensure financially sound banks and a stable and strong national economy.

The Board of Governors, located in Washington, D.C., is the federal government agency that regulates banks, contributes to the nation's monetary policy, and oversees the activities of Reserve Banks.

Governors actively lead committees that study prevailing economic issues—from affordable housing and consumer banking laws to interstate banking and electronic commerce. The Board of Governors also exercises broad supervisory control over certain state-chartered financial institutions, called member banks, as well as the companies that own banks (bank holding companies). This control ensures that commercial banks operate responsibly and comply with federal regulations and that the nation's payments system functions smoothly. In addition, the Board of Governors oversees the activities of Reserve Banks, approving the appointments of each Reserve Bank's president and three members of its board of directors. The Governors' most important responsibility is participating on the FOMC, the committee that directs the nation's monetary policy.

Heading the Board of Governors are a Chair and Vice Chair, who are Governors whom the president of the United States appoints to serve four-year terms. The current Chair of the Board of Governors is Janet Yellen. This is a highly visible position.

The Chair reports twice a year to Congress on the Fed's monetary policy objectives, testifies before Congress on numerous other issues, and meets periodically with the secretary of the Treasury. Other Board of Governors officials are also called to testify before Congress, and they maintain regular contact with other government organizations as well.

As the Federal Reserve's centralized component, the seven members of the Board of Governors guide the Federal Reserve's policy actions, study trends in the economy, and help forecast the country's future economic direction. The Governors also participate in monetary policymaking on the FOMC. In addition, the Board of Governors is responsible for regulations to keep the banking system sound and for overseeing the operations of the 12 Reserve Banks. In a later section, you will learn how the Reserve Banks supervise their member banks to ensure they comply with these regulations.

Janet Yellen became the Chair of the Board of Governors on Feb. 3, 2014.

Introduction to the Federal Reserve Banks

Visit a Federal Reserve Bank and you'll see that its operations resemble the activities in private businesses.

The structure of the Federal Reserve is complex, yet effective. Reserve Banks operate somewhat independently but under the general oversight of the Board of Governors. These Reserve Banks, and their branches, are strategically located in large cities across the country. The economists and other employees in each of the 12 Federal Reserve Districts work together to provide a regional perspective and expert knowledge about their local economies. Reserve Bank activities serve primarily three audiences—bankers, the U.S. Treasury, and the public:

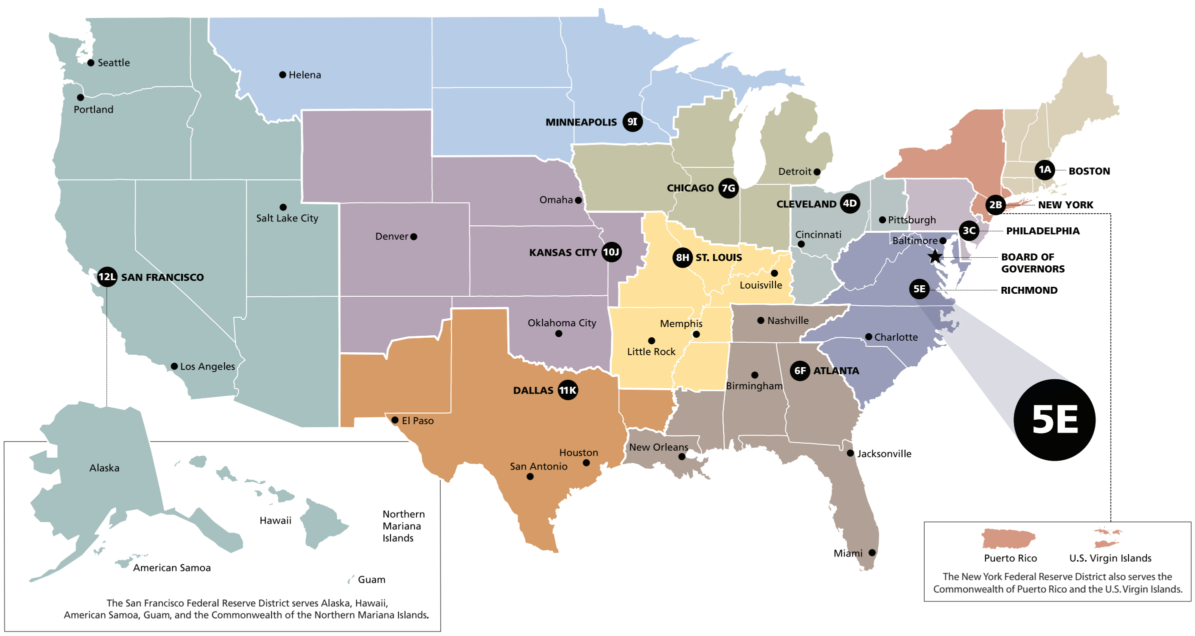
- Federal Reserve Banks are often called the "bankers' banks" because they provide services to commercial banks similar to the services that commercial banks provide for their customers. Federal Reserve Banks distribute currency and coin to banks, lend money to banks, and process electronic payments. At one point, workers' paychecks and the checks written to pay mortgages and most other bills were sent to one of the 12 Reserve Banks, where the checks were processed to settle the debt. However, now the Federal Reserve Bank of Cleveland handles all of the Federal Reserve's check processing. Why do you think only one Reserve Bank currently processes checks? It's because there was a significant decline in the use of paper checks and an increase in electronic imaging and online bill paying.

- Reserve Banks also serve as fiscal agents for the U.S. government. They maintain accounts for the U.S. Treasury, process government checks, and conduct government securities auctions.

- Finally, Reserve Banks conduct research on the regional, national, and international economies; prepare Reserve Bank presidents for their participation on the FOMC; and distribute information about the economy through publications, speeches, educational workshops, and websites.

Federal Reserve Banks conduct research on the economy, supervise banks in their regions, and provide financial services to banks and the U.S. government.

The Fed's Regional Structure



This map highlights the 12 Reserve Bank Districts and identifies each District with its designated number and letter plus its headquarters and branches.

Notice that the districts in the Northeast tend to be very small, while those in the West are very large. This size discrepancy relates to the population distribution in 1913, when the population was heavily concentrated along the East Coast.

The Federal Reserve System has adapted to changing population patterns by adding branch offices in the Districts. For example, the Twelfth District is very large geographically and includes Hawaii and Alaska. This District has four branches in addition to its headquarters in San Francisco.

The Federal Reserve Banks and Currency

Did you know that Federal Reserve Banks place the currency you use to make purchases into circulation? Each bill has a number and a letter that denote the Federal Reserve Bank that accounts for that particular bill. For example, a bill with the number 8 will have the letter H (the eighth letter in the alphabet), which means it appears on the balance sheet of the Federal Reserve Bank of St. Louis.

For the recently redesigned $5, $10, $20, $50, and $100 bills, the letter and number that identify the Federal Reserve Bank are beneath the left serial number on the face of the bill.

Who Owns Reserve Banks?

The Federal Reserve Banks are not a part of the federal government, but they exist because of an *act of Congress*. Their purpose is to serve the public. So is the Fed *private* or *public*?

The answer is *both*. While the Board of Governors is an independent government agency, the Federal Reserve Banks are set up like private corporations. Member banks hold stock in the Federal Reserve Banks and earn dividends. Holding this stock does not carry with it the control and financial interest given to holders of common stock in for-profit organizations. The stock may not be sold or pledged as collateral for loans. Member banks also appoint six of the nine members of each Bank's board of directors.

On Dec. 23, 1913, President Woodrow Wilson signed the Federal Reserve Act. Over the next year, a selection committee made up of Secretary of the Treasury William McAdoo, Secretary of Agriculture David Houston, and Comptroller of the Currency John Williams decided which U.S. cities would be a place of residence for one of 12 Federal Reserve District Banks.

Reserve Bank Board of Directors

Each Reserve Bank has its own board of directors, which oversees the Bank's activities. These directors contribute local business experience, community involvement, and leadership and reflect the diverse interests of each District. Each board had nine members. Six of the directors are elected by member commercial banks. Three of the directors are appointed by the Board of Governors. From among these three, the Board of Governors selects a chairman and a deputy chairman of the given Bank's board. You can learn about each Federal Reserve Bank's current board of directors by visiting each Bank's website.

Reserve Banks and Policy

Reserve Banks carry out the Fed's policies at a regional level. Day to day, the banks execute the banking and consumer protection laws enacted by Congress and the regulatory policies adopted by the Board of Governors. The Reserve Banks also play a critical role in bringing local economic perspectives to the national arena.

For example, an economist at a Reserve Bank may learn of the anticipated expansion or shutdown of a major local employer. Such news will obviously affect the local economic outlook, but will it affect the national economy? The economist's expertise and her familiarity with the region can help policymakers—such as the Reserve Bank presidents—evaluate the extent of the impact of the major employer's business decision on the local economy.

Reserve Banks publish research, articles, and economic forecasts that people who live in their District might find useful. Also, because Reserve Bank staff members interact directly with local bankers—examining their books and offering financial services—they are knowledgeable about the effects of national policies on local banks and can funnel that information to the Board of Governors.

The Reserve Banks do much more than just add regional perspectives, though. The Banks also contribute to the ongoing exchange of ideas across the Federal Reserve System that allows the Fed to make better policy. This tradition of independent thought is one of the strengths of the Fed's decentralized structure.

When Congress created the Federal Reserve System in 1913, it established 12 Federal Reserve Districts so that every part of the country would be represented in the System. Each District has a Federal Reserve Bank that serves and supervises member banks in that particular District.

The Federal Reserve Banks represent their Districts in the broader Federal Reserve System. One of the most important venues where the Reserve Banks represent their Districts is at the meetings of the FOMC, the topic of our next section.

Introduction to the FOMC

The Federal Open Market Committee, or FOMC, is the Fed's chief body for monetary policy. Its voting membership combines the seven members of the Board of Governors, the president of the Federal Reserve Bank of New York, and four other Reserve Bank presidents, who serve one-year terms on a rotating basis with the other Reserve Bank presidents. All Reserve Bank presidents attend FOMC meetings, however, even when they are not designated voting members. By tradition, the chairman of the FOMC is also the Chair of the Board of Governors.

The chart below shows the voting schedule for the FOMC. As noted, the president of the Federal Reserve Bank of New York and members of the Board of Governors are permanent voting members. Most Reserve Bank presidents serve one-year terms on a three-year rotating schedule; however, the presidents of the Cleveland and Chicago Feds serve on a two-year rotating schedule. For example, in Year 1 the presidents of the Boston, Cleveland, St. Louis, and Kansas City Feds serve as voting members.

FOMC Voting Members

Permanent Voting Members New York Fed President Board of Governors (including Chair)
Voting Rotation Schedule of Federal Reserve Bank Presidents **Year 1—Voting Members** Boston Cleveland* St. Louis Kansas City
Year 2—Voting Members Philadelphia Chicago* Dallas Minneapolis
Year 3—Voting Members Richmond Cleveland* Atlanta San Francisco

**Cleveland and Chicago are on a two-year rotating schedule.*

The FOMC typically meets eight times a year in Washington, D.C. If economic conditions require additional meetings, the FOMC can and does meet more often.

The following occurs at each meeting:

- A senior official at the Federal Reserve Bank of New York discusses developments in the financial and foreign exchange markets, as well as activities of the New York Fed's Trading Desk, where U.S. government securities are bought and sold.
- Staff from the Board of Governors then present their economic and financial forecasts.

- The Board's Governors and all 12 Reserve Bank presidents—whether they are voting members that year or not—offer their views on the economic outlook.

Armed with this wealth of up-to-date national, international, and regional information, the FOMC discusses the monetary policy options that would best promote the economy's sustainable growth.

After all participants have deliberated the options, members vote on a policy that is given to the New York Fed's Trading Desk. The policy directive informs the Desk of the Committee's objective for "open market operations"—whether to maintain or alter the current policy. The Desk then buys or sells U.S. government securities on the open market to achieve this objective.

A Closer Look at Open Market Operations

The term "open market" means that the Fed doesn't decide on its own the securities dealers with which it will do business. Instead, various securities dealers compete on the basis of price in the government securities market.

The FOMC sets a target for the federal funds interest rate and attempts to hit the target by buying or selling government securities.

How do open market operations actually work? Currently, the FOMC establishes a target for the federal funds rate (the rate banks charge each other for overnight loans). Banks take overnight loans to ensure that they have the necessary funds to meet the reserve requirements of the Federal Reserve System—a topic that is addressed later. The federal funds rate is important because movements in the rate influence other interest rates in the economy. For example, if the federal funds rate rises, the prime rate, home loan rates, and car loan rates will likely rise as well.

The Federal Reserve uses open market operations to arrive at the target rate. Open market operations consist of the buying or selling of government securities. The Fed holds government securities, and so do individuals, banks, and other financial institutions such as brokerage companies and pension funds.

As mentioned before, open market operations involve buying and selling government securities. We refer to the Fed's purchase of government securities as expansionary monetary policy and its sale of government securities as contractionary monetary policy. In the next section, you will learn more about what expansionary and contractionary policy mean.

Expansionary Policy

Open market purchases of government securities increase the amount of reserve funds that banks have available to lend, which puts downward pressure on the federal funds rate. Policymakers call this easing, or expansionary monetary policy. If the economy were a car and the FOMC its driver, expansionary policy would be like gently pushing on the accelerator—giving the economy a little more fuel.

Expansionary Monetary Policy

Step: 1	When the Fed buys government securities through the securities dealers in the bond market, it deposits the payment into the bank accounts of the banks, businesses, and individuals who sold the securities.
Step: 2	Those deposits become part of the funds in commercial bank accounts that commercial banks hold at the Federal Reserve and thus part of the funds that commercial banks have available to lend.
Step: 3	Because banks want to lend money, to attract borrowers they decrease interest rates, including the rate banks charge each other for overnight loans (the federal funds rate).

Contractionary Policy

Sales of government securities shrink the funds available to lend and tend to raise the federal funds rate. Policymakers call this tightening, or contractionary monetary policy. Again, if the economy were a car and the FOMC its driver, contractionary policy would be like lightly tapping on the brakes—not enough to stop the car, but rather to slow its momentum a bit.

Contractionary Monetary Policy

Step: 1	When the Fed sells government securities, buyers pay from their bank accounts, which decreases the amount of funds held in their bank accounts.
Step: 2	Banks then have less money available to lend.
Step: 3	When banks have less money to lend, the price of lending that money—the interest rate—goes up, and that includes the federal funds rate.

The FOMC uses open market operations like an accelerator and brake pedal to influence economic performance. By targeting the federal funds rate, the FOMC seeks to provide the monetary stimulus needed for a healthy economy. After each FOMC meeting, the federal funds rate target is announced to the public.

Conducting Monetary Policy

Keeping our economy healthy is one of the most important jobs of the Federal Reserve. The Federal Reserve System has been given a dual mandate—pursuing the economic goals of **price stability** and **maximum employment.** It does this by managing the nation's system of money and credit—in other words, conducting monetary policy.

The first part of the Fed's dual mandate is price stability, which means that the economy is not experiencing high or variable inflation or deflation. Experience has shown that the economy performs well when inflation is low and is expected to remain low—because interest rates are usually low as well.

> "Economists like to argue that money belongs in the same class as the wheel and the inclined plane among ancient inventions of great social utility. Price stability allows that invention to work with minimal friction."
>
> **Former Chairman Ben Bernanke**
> *Feb. 24, 2006, speech at Princeton University*

Low interest rates allow businesses to borrow money for expansion and hiring additional workers. Such an environment promotes low unemployment and allows the economy to achieve its growth potential. Free from the disruptive effects of high and variable inflation, consumers and producers make economic decisions with confidence.

The ability to maintain stable prices is a long-term measure of the Fed's success. To achieve this, the Fed sets a variety of targets, including:

- the amount of money circulating in the economy,
- the level of reserves held by banks, and
- the level of interest rates.

The Fed constantly measures the effects of its policies on the economy. The Federal Reserve System has set a long-run goal for inflation at the rate of 2 percent. So, the inflation rate may fluctuate a bit, but it should average 2 percent over the long run.

The actions that the Fed takes today influence the economy and the inflation rate for some time to come. Policymakers must be forward-looking and take action to head off inflation or deflation before either becomes a problem.

Inflation isn't healthy for the economy, but neither is deflation.

Deflation occurs when the average price level is falling throughout the economy, so the inflation rate is negative. While this might sound good for consumers, it can cause some major problems for the economy. Note that this is different from disinflation.

Disinflation is a decrease in the inflation rate—say, from 4 percent to 3 percent a year. Notice that the economy still has a 3 percent inflation rate—the inflation rate is just lower than before.

The goal of the Federal Reserve System is to promote stable prices. When prices are stable, consumers and producers can make their spending and investing decisions without worrying that the value of their money will change dramatically—up or down—in the near future.

Think about it …

If inflation has been low and steady at 2 percent per year for many years, you might expect that inflation will remain at 2 percent in the future and plan accordingly. If, however, inflation were 2 percent one year, 8 percent the next, and 12 percent this year, it would be difficult to know how to save, spend, or invest your money.

The second part of the Fed's dual mandate is **maximum employment**. Maximum employment is the level at which cyclical unemployment—the type that rises during economic downturns—is eliminated. The Federal Reserve has been given the task of using its monetary tools to boost an economy as it starts to weaken.

The dual mandate is a difficult objective because concentration on one variable puts the other at risk. For example, if the Fed were to attempt to drive unemployment to continually lower levels by pressuring interest rates lower and lower, consumers would borrow increasing amounts of money to buy houses, cars, furniture, and vacations. Production could not keep up with the demand for goods, and the prices of those goods would begin to rise—inflation would likely get out of hand. On the other hand, if the Fed were to become overly concerned about inflation and refuse to allow the money supply to expand quickly enough, consumers would buy less and businesses would delay expansion plans. Unemployment would likely rise, perhaps to painful levels.

Back to our car analogy—the dual mandate is like driving on an interstate with a minimum and maximum speed limit. The FOMC's goal is to keep the car—or in this case, the economy—going at a fast, but safe, speed. If the car starts to slow or encounters a hill, the driver may have to give it a bit more gas to maintain speed, but when the car starts to go too fast, the driver will have to ease up on the gas or even tap on the brakes to slow its momentum. In this way, the driver—or the FOMC—must always be mindful of conditions and changes in the road ahead.

How Monetary Policy Works

The Fed can use three tools to achieve its monetary policy goals: the discount rate, reserve requirements and open market operations. All three affect the amount of funds in the banking system.

- The **discount rate** is the interest rate Reserve Banks charge commercial banks for short-term loans. Federal Reserve lending at the discount rate complements open market operations in achieving the target federal funds rate and serves as a backup source of liquidity for commercial banks. Lowering the discount rate is expansionary because the discount rate influences other interest rates. Lower rates encourage lending and spending by consumers and businesses. Likewise, raising the discount rate is contractionary because the discount rate influences other interest rates. Higher rates discourage lending and spending by consumers and businesses. Discount rate changes are made by Reserve Banks and the Board of Governors.

- **Reserve requirements** are the portions of deposits that banks must hold in cash, either in their vaults or on deposit at a Reserve Bank. A decrease in reserve requirements is expansionary because it increases the funds available in the banking system to lend to consumers and businesses. An increase in reserve requirements is contractionary because it reduces the funds available in the banking system to lend to consumers and businesses. The Board of Governors has sole authority over changes to reserve requirements. The Fed rarely changes reserve requirements.

- By far, the most frequently used tool is **open market operations,** the buying and selling of U.S. government securities. As we learned earlier, this tool is directed by the FOMC and carried out by the Federal Reserve Bank of New York.

Gathering Data

Research economists at all 12 Reserve Banks, as well as at the Board of Governors, contribute to the policymaking process. Generally speaking, economists at Reserve Banks monitor the economies of their Districts as well as the national economy. The primary duty of the economists is to prepare their Reserve Bank president for his or her participation in FOMC meetings.

Members of the research staff gather, analyze, evaluate, and share information about the economy. Before each FOMC meeting, for example, researchers survey key industry contacts within their Districts and assemble a report called the *Beige Book*, which can often highlight meaningful trends in economic activity before they show up in national statistics. The *Beige Book* serves as an up-to-the-minute resource for FOMC discussions and its contents are widely reported in the press.

The loans and deposit data that Reserve Banks collect from depository institutions are some of the most critical statistics the Fed gathers. Such information is used in analyzing regional and national bank performance, credit demand, and other banking concerns.

Determining how to interpret all this information is the hard part, of course. At the Board of Governors, economists use data to forecast potential outcomes of various economic scenarios. All the while, the economists look for key information that will contribute to better monetary policy. The variety of research interests around the Federal Reserve System fosters a diversity of views and influences wider economic thought.

Spreading the Word

The Federal Reserve shares the viewpoints that emerge from its research. Besides producing publications for audiences of all kinds, Fed speakers address numerous groups on the economic outlook, participate in professional forums, conduct educational seminars for area teachers, provide economic information for local reporters, develop publications about the economy and the Fed for the public, and develop lessons and online tools about the economy for use in classrooms. Websites at each Reserve Bank and at the Board of Governors broaden the reach of the Federal Reserve's economic expertise.

The previous two sections described the roles of the Federal Reserve Banks and the FOMC in monetary policy. The Federal Reserve's dual mandate is to provide price stability and maximum employment. Achieving these goals requires using monetary policy to influence the money supply, interest rates, and economic growth. While the Fed's monetary policy function is the task that gets the most attention, the Federal Reserve System has many other roles.

Supervision and Regulation: An Introduction

Have you ever been in a panic? Your heart pounds, you start to sweat, and your stomach feels queasy. Imagine hearing that the bank holding your life savings is running out of money. Imagine the panic you feel as you run to that bank to get whatever you can before the doors are closed and locked forever. Now, imagine having nothing but your savings to support you through your later years. Social Security doesn't exist and you don't have a pension. All you have is your savings, and now it could be gone. Forever.

The nation's periodic episodes of banking panics were one of Congress' most serious concerns in creating the Federal Reserve and led to one of the Fed's three main responsibilities: to foster safe, sound, and competitive practices in the nation's banking system.

To accomplish this, Congress included the Fed among those responsible for regulating the banking system and supervising financial institutions. What's the difference between these two responsibilities?

For the Fed, supervising banks generally means helping to establish safe and sound banking practices and protecting consumers in financial transactions.

Bank Regulation
Bank regulation refers to the written rules that define acceptable behavior and conduct for financial institutions. The Board of Governors, along with other bank regulatory agencies, carries out this responsibility.

Bank Supervision
Bank supervision refers to the enforcement of these rules. The 12 Reserve Banks carry out this responsibility, supervising state-chartered member banks, the companies that own banks and thrifts, international organizations that conduct banking business in the United States, and some companies that are not banks at all, but, nevertheless, are important to the financial system. In addition to the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) also supervise financial institutions.

Safety and Soundness

The nation's banking system is only as safe and sound as the banks within the system. So the Federal Reserve examines banks regularly to identify and contain bank risks.

In the past, Reserve Bank examiners reviewed each bank in much the same way—looking over the bank's books on-site and evaluating the quality of its assets and its ability to cover loan losses. Today, Fed examinations are more customized for each bank. Examinations take into account that each bank differs markedly in its services and products and that a bank's own management should be held responsible for monitoring the institution's exposure to risks.

By studying the bank's risk-management procedures and internal controls, Reserve Bank examiners assess whether a bank lends money wisely and can manage the level of loans it makes to customers. Examiners also review a bank's performance in complying with its own internal policies, as well as with federal and state laws and regulations.

At the end of an on-site review, Fed examiners issue the bank a rating that reflects the institution's condition. The rating indicates whether the institution is sound enough to withstand fluctuations in the economy or whether it has weaknesses that require correction. Between examinations, Reserve Banks monitor financial institutions by examining bank reports filed with the Fed.

New responsibilities were assigned to the Federal Reserve by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act. The Federal Reserve was given important authority to monitor large or complex financial organizations that could pose a threat to the stability of our nation's economy or financial system. To do this, the Chair of the Federal Reserve Board is a member of an oversight group established by the act, the Financial Stability Oversight Council (FSOC). The FSOC will identify those companies or practices that pose significant risk.

The Federal Reserve was also given authority to regulate and oversee companies that own savings and loan institutions. Previously, these financial institutions were supervised by the Office of Thrift

Supervision, which was eliminated as part of the act.

Bank examiners use a CAMELS rating to describe a bank's soundness. Examiners rank the bank in the following six categories. Banks are issued points from 1 to 5, where 1 is the highest rating and 5 is the lowest.

CAMELS Rating		Generic bank example rating
Capital adequacy	Does the bank have enough money, loan income, and investments to cover its deposits and business costs?	2
Asset quality	Is the bank making loans that are likely to be paid back? Are the bank's investments likely to be profitable?	3
Management	Does the bank's management make sound decisions?	2
Earnings	Is the bank making a reasonable profit?	4
Liquidity	Does the bank have enough money on hand or is its money tied up in assets?	3
Sensitivity	How sensitive is the bank to market risk? For example, if most of the bank's loans are home mortgages, what will happen to the bank if the housing market shrinks?	3

Consumer Protection

Another Fed goal is to protect consumers in lending and deposit transactions.

Fed examiners specially trained in consumer compliance laws examine banks and thrifts with assets of $10 billion or less to be certain that consumer loan applications are judged on the basis of the consumer's ability to repay the loan and not on the consumer's race, gender, age, neighborhood of residence or other discriminatory practice. Fed examiners not only ensure that credit costs and interest rates are stated accurately, but they also make sure they are stated clearly. For example, borrowers must not only be told the interest rate, but they must also be told the annual percentage rate (APR) for a loan.

Community Development departments at Federal Reserve Banks also help local institutions broaden access to loans by bringing together lenders, government agencies, nonprofit corporations, and community development groups.

Other Fed responsibilities include examining mortgage lending companies that are subsidiaries of banks to be certain they are lending to people who can afford to pay back the loan and to be sure they are charging a reasonable interest rate. The Fed also regulates credit card companies in one area of business—debit cards. Consumers use debit cards to make purchases in lieu of using cash or checks; the purchase amount is deducted immediately from the card holder's bank account. Merchants accept debit cards but must pay a transaction fee to the issuing credit card companies for each debit card purchase. The Federal Reserve regulates the credit card companies to ensure that these companies do not charge merchants fees that are much higher than the costs of processing the merchants' debit card transactions.

Discount Window Lending

It's late afternoon, and Flanders Community Bank is short on the available cash it is required to hold in reserves. It has plenty of assets, such as loans it has made to customers for cars, homes, or education. However, it must have the required cash in case its customers come to the bank to make withdrawals. For example, consider what might happen if a customer came in for a $1,000 withdrawal and, instead of cash, the teller offered the customer a different customer's car loan.

The conversation might go like the following scenario.

Customer: Good morning, I would like to withdraw $1,000 from my account.

Teller: OK. Here you are. This is a promissory note another of our customers signed when he borrowed money from us to buy a car. In this loan contract, he states he will pay back $1,000. Of course, that means that this note is worth $1,000.

Customer: Wait a minute! This is no good to me. I can't spend this right now. This isn't liquid. It will take too long to convert this into cash—and I need cash!

It's important that Flanders Community Bank not be caught short on cash because it cannot pay its customers in other people's loans and other nonliquid assets. However, what happens when it's late in the day and too late to arrange an overnight loan from a fellow bank? How will this bank get the cash it needs? Flanders has another option: It can borrow the cash from the Federal Reserve.

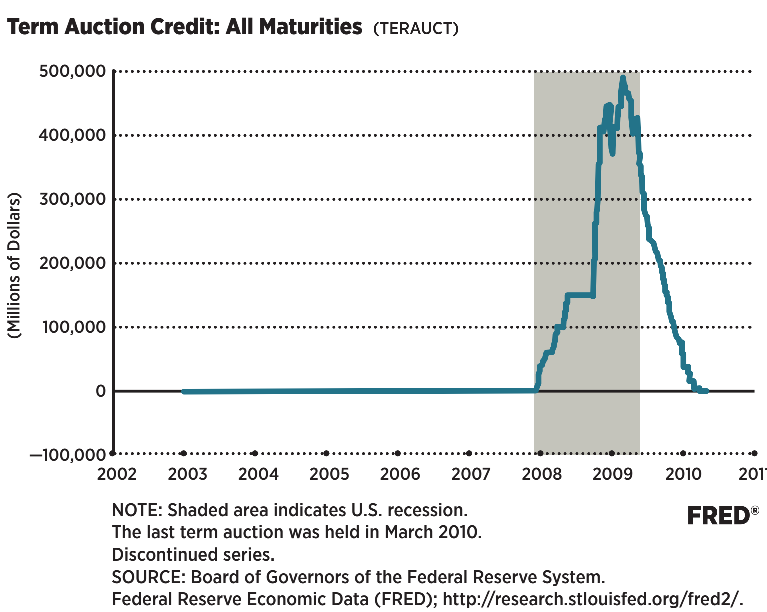
One of the most important ways that the Fed provides **liquidity** to the banking system is by offering funds for loans through its discount window. Traditionally, banks would come to the discount window for loans only when they could not borrow from any other institution.

However, from December 2007 through March 2010, the Fed used the discount window in a new way to help sound banks obtain additional funds that they could then lend to businesses and consumers. One new method for lending money to banks through the discount window was the **Term Auction Facility**, the TAF for short.

The TAF worked like this:

- Every two weeks, the Fed would determine the amount of money it wanted to lend on a particular day. It would set a minimum interest rate at which it was willing to lend the money.
- The banks that wanted to borrow would bid on the amount of money they wanted to borrow and the interest rate they were willing to pay.
- The Fed would sort the bids according to the interest rate offered.
- Beginning with the highest interest rate and working its way down, the Fed would add the amounts of money requested until the amount requested equaled the amount the Fed wanted to lend. The interest rate charged would be equal to the lowest rate offered among the banks whose bids were accepted.

The Fed lends money to banks so that a shortage of funds at one institution does not disrupt the flow of money and credit in the entire banking system.



Providing Financial Services

When Congress established the Federal Reserve, it charged the Fed with the critical task of providing a safe and efficient method of transferring funds throughout the country's banking system. Reserve Banks and their branches carry out this mission, offering financial services to all financial institutions in the United States, regardless of size or location.

Essentially, Reserve Banks serve as bankers' banks, offering a variety of financial services. They distribute currency and coin, process checks, and offer electronic forms of payment.

Traditional Forms of Payment

Regional Reserve Banks meet the public demand for currency and coin within their Districts. Sometimes, people want to hold more of their assets in cash (currency and coin).

The transition from Dec. 31, 1999, to Jan. 1, 2000, involved more than the usual New Year's Eve celebrations. Many people stocked up on drinking water, fearing that the water companies' systems would fail. People avoided flights, fearing that planes would begin falling from the sky at the stroke of midnight. And, many people withdrew large sums of cash from their bank accounts for various reasons; they feared that stores would stop taking checks or debit cards, or they thought their bank accounts would suddenly contain no money. All this disruption was the result of a feared computer glitch related to the change of century date from 1999 to 2000. These problems never materialized and people redeposited their money into their checking and savings accounts shortly after New Year's Day. However, when people wanted to hold more cash, the Fed made sure the currency and coin was available.

Besides providing currency and coin, Reserve Banks process commercial checks. Over the past decade, the Fed has led the industry's push to replace paper forms of payment, such as checks, with electronic forms of payment that offer lower risk and higher efficiency. The Fed now transmits electronic images of checks and allows electronic deposits and payments.

In 2012, the Fed processed approximately **6.6 billion** paper check transactions. In the near future, the Fed anticipates that at least 95 percent of these will be electronic transactions.

Electronic Forms of Payment

Every day, billions of dollars are transferred electronically among U.S. financial institutions. The Reserve Banks provide two electronic payment services: funds transfer and the automated clearinghouse, or ACH.

The funds transfer service provides a communications link among financial institutions and government agencies. Funds transfers are usually for high-dollar amounts—they can average several million dollars or more. Funds transfers originate and are received through a sophisticated telecommunications network known as Fedwire®*, which links all Reserve Banks electronically. Institutions can move their balances at the Fed or send funds to another institution through this network. Most transactions sent over Fedwire are bank-to-bank transfers of funds, made on behalf of bank customers.

The ACH provides a nationwide network to exchange paperless payments among financial institutions and government agencies. If you have a job and your paycheck is directly deposited into your checking account, it is sent through the ACH. Your paycheck is a credit transfer. Other types of credit transfers are Social Security checks and income tax refunds. Often, people arrange to have regularly occurring bills, such as the electric bill or their mortgage, paid electronically. These types of payments are debit transfers.

Meanwhile, other forms of electronic payment—like smart cards and debit cards—have become consumer staples. While the Fed does not directly provide these services, it does provide research and development of universal standards to ensure the safety, convenience, and accessibility of these forms of payment.

The Fed as a Fiscal Agent

In addition to serving as the bankers' bank, the Federal Reserve System acts as the bank for the U.S. government. Federal Reserve Banks maintain accounts for the U.S. Treasury; process government checks, postal money orders, and U.S. savings bonds; and collect federal tax deposits. When the Treasury offers new issues of marketable securities to the public, certain Reserve Banks provide information about the issues, process orders from customers, collect payments, and credit the Treasury's account for the proceeds.

The Fed and the U.S. Treasury process and deliver these services electronically.

Conclusion

Independence and Accountability

The Federal Reserve Act was enacted nearly a century ago. Under the law, the Federal Reserve was made accountable to Congress but also was specifically designed to carry out its responsibilities without interference or control from the vested interests inherent in electoral politics, fiscal policymaking, and private banking. In short, the Fed was created as an independent central bank.

For example, Federal Reserve officials cannot be fired simply because the president or a member of Congress disagrees with Federal Reserve decisions about interest rates. Similarly (as you learned earlier) although commercial bankers serve as members of Federal Reserve Banks' boards of directors, they do not establish banking regulations.

**Fedwire® is a registered service mark of the Federal Reserve Banks.*

Most nations in the developed world today have an independent central bank. International studies have consistently shown that central banks with a higher degree of independence are more effective at maintaining stable price levels.

With independence, however, comes the obligation for a central bank to be accountable and transparent: It must provide open communication and access to any information that is needed to allow others to understand its decisions. Transparency also ensures the integrity of operations.

Here are a few examples of how the Federal Reserve System is held accountable:

- The Board of Governors is nominated by the president of the United States and must be confirmed by the Senate.
- The Chair of the Board of Governors must give regular reports to Congress.
- The minutes of FOMC meetings are released to the public after a short time lag.
- The president of each Federal Reserve Bank is chosen by a local board of directors, but the selection must be approved by the Board of Governors.
- Each Federal Reserve Bank is audited every year by independent auditors.
- The budget of each Federal Reserve Bank must be approved by the Board of Governors.

Summary

The past several sections have introduced you to the Federal Reserve—the Board of Governors, the 12 Reserve Banks, and the FOMC—as well as what it does.

You have learned about the Fed's three main responsibilities—conducting monetary policy, supervising banks, and providing financial services. You've also been given an overview to help you make sense of the complex, yet effective, functioning of the Federal Reserve System.

What becomes apparent is not only how important the Fed is to the economy, but also how effective the Fed's structure is for fulfilling the purposes of the Federal Reserve System. A financial crisis led to the creation of the Fed, and a financial crisis is exactly what the Federal Reserve is best prepared to handle. Should a financial crisis arise in any part of the country, a Reserve Bank is close at hand with the banking and payments system expertise and emergency funds necessary to respond quickly.

Through the combined efforts of the Board of Governors, the Reserve Banks, and the FOMC, the Federal Reserve System is in a strong position to make monetary policy, provide a safe banking system, and contribute to an effective payments system, all of which contribute to a healthy economy.

Thanks for visiting the Federal Reserve Bank of St. Louis' website. For additional resources, visit **www.stlouisfed.org/education_resources/consumers/.**