

In Plain English:
MAKING SENSE OF THE FEDERAL RESERVE

Warning!

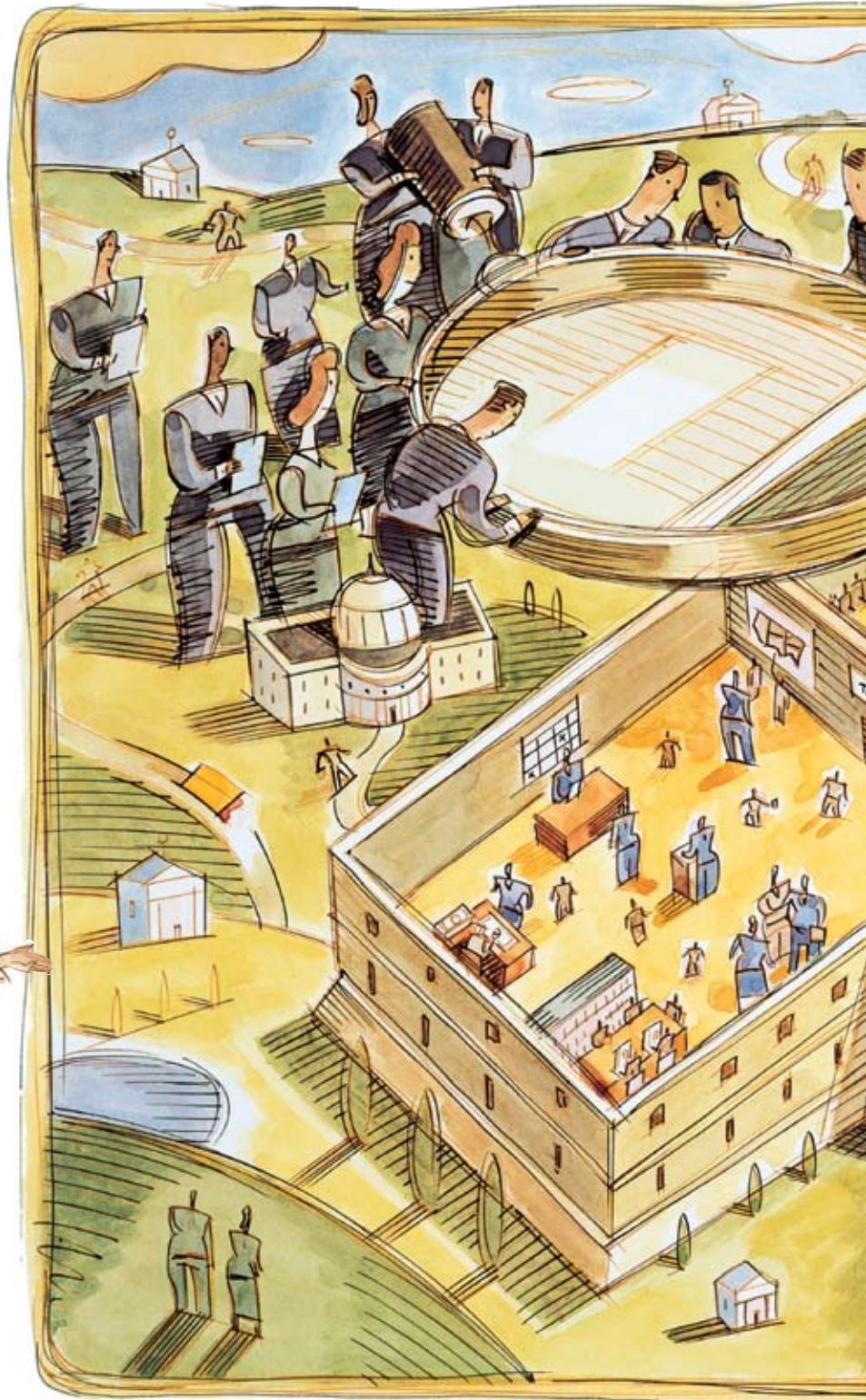
The illustration you are about to uncover may overwhelm you at first glance, but trust us. We'll make sense of it together and discover not only who makes up the Federal Reserve, but also what exactly we do. Stick with us, and by the time we end this tour, you too will be able to explain the Federal Reserve in plain English.

Wow!

We weren't kidding; there's a lot happening on this page! Truth is, there's a lot going on in the Federal Reserve System. But keep in mind that the whole is really just the sum of its parts.

Basically, the Federal Reserve (or as most people call it, the Fed) consists of three parts: the Board of Governors (building at left), Reserve banks (12 buildings at right) and the Federal Open Market Committee (meeting room inside the Board of Governors).

Congress and the White House are here, too, but we'll touch on their roles later.





THE FEDERAL RESERVE SYSTEM

First Things First

WHY A FEDERAL RESERVE SYSTEM

In Plain English:

The Federal Reserve was created in 1913 in response to the nation's recurring banking panics; its mission has since expanded into fostering a healthy economy.

Before we dig into the Fed's structure and how it works, let's start with some background on the Federal Reserve—how and why we were created in the first place.

Just before the founding of the Federal Reserve, 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. 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. Initially created to address these banking panics, the Federal Reserve is now charged with a number of broader responsibilities, including fostering a sound banking system and a healthy economy.

Establishing the nation's first central bank was no simple task. Although the need for banking reform was undisputed, for decades early supporters debated the delicate balance between national and regional interests. On a national front, the central bank had to be structured to facilitate the exchange of payments

among regions and to strengthen the U.S. standing in the world economy. On a regional front, the central bank had to be responsive to local liquidity needs, which could vary across regions.

Another critical balancing act was that between the private interests of banks and the centralized responsibility of government. What emerged with the Federal Reserve System was a central bank under public control, with countless checks and balances.

As our diagram illustrates, 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 insulated from political pressure. Each of the Fed's three parts—the Board of Governors, the regional Reserve banks and the Federal Open Market Committee—operates independently of the federal government to carry out the Fed's core responsibilities.

Now let's break down the structure and responsibilities on the following pages—to see who we are and then what we do.



THE FEDERAL RESERVE SYSTEM

Who We Are

BOARD OF GOVERNORS

In Plain English:

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

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—called governors—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. The appointments to the Board are staggered—one term expiring every two years—to ensure stability and continuity in the group. The seven governors, along with a host of economists and support staff, help write the policies that make our banks financially sound and help formulate the policies that make our nation economically strong.

Governors actively lead committees that study prevailing economic issues—from affordable housing and consumer banking laws to interstate banking and electronic commerce. The Board also exercises broad supervisory control over certain state-chartered financial institutions, called member banks, as well as the companies that own banks. 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 oversees the activities of Reserve banks, approving the appointments of their presidents and three members of the Reserve banks' boards of directors. Probably the Board's most important responsibility is participating on the Federal Open Market Committee (FOMC), the committee that directs the nation's monetary policy. (See page 7.)

Heading the Board are a chairman and vice chairman, who are appointed by the U.S. president to serve four-year terms. The chairman of the Board of Governors has a highly visible position. Indeed, when the chairman speaks, Wall Street and the public listen!

The chairman 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 officials are also called to testify before Congress, and they maintain regular contact with other government organizations as well.

Who We Are

FEDERAL RESERVE BANKS

In Plain English:

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

Visit a Federal Reserve bank, and you'll see that its operations resemble the activities that go on in private business.

Reserve banks are the *decentralized* components of the Fed's structure, meaning that they operate somewhat independently but under the general oversight of the Board of Governors. Reserve banks contribute to national policy discussions, providing a regional banking perspective and the expert knowledge about their local economies. This decentralized structure is a good example of the Federal Reserve's complex, yet effective, design.

The Federal Reserve System is divided into 12 districts. Each district is served by a regional Reserve bank. Most Reserve banks have one or more branches. (See pages 8 and 9.)

Reserve bank activities serve primarily three audiences—bankers, the U.S. Treasury and the public. Reserve banks are often called the “bankers’ banks” because they store commercial banks’ excess currency and coins and they process and settle their checks and electronic payments. Reserve banks also supervise commercial banks in their regions.

As banks for the U.S. government, Reserve banks process the Treasury's payments, sell its securities and assist with its cash management and investment activities. Finally, Reserve banks conduct research on the national and regional economies, prepare Reserve bank presidents for their participation on the FOMC and disseminate information about the economy through publications, speeches, educational workshops and web sites.

Each Reserve bank has its own board of directors, which oversees the activities of the organization. These directors contribute local business experience, community involvement and leadership, and they reflect the diverse interests of each district. The boards have nine members: Six, including the chairman and deputy chairman, represent the public, while three represent banking. (Reserve bank branch offices have smaller boards of directors.)

The boards of directors impart to Reserve banks a private-sector management perspective that emphasizes efficiency and quality. The boards also appoint presidents of their respective Reserve banks, with the approval of the Board of Governors.



THE FEDERAL RESERVE SYSTEM

Who We Are

FEDERAL OPEN MARKET COMMITTEE

In Plain English:

The FOMC determines the nation's monetary policy to help foster a healthy economy.

The Federal Open Market Committee, or FOMC, is the Fed's chief body for monetary policymaking. 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. The chairman of the FOMC is also the chairman of the Board of Governors.

The FOMC typically meets eight times a year in Washington, D.C. At each meeting, a senior official of 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 domestic and foreign trading desks. (Read about the New York Fed's role in monetary policy on pages 10 and 11.) Staff from the Board of Governors then present their economic and financial forecasts. In addition, 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 directive that is issued to the New York Fed's domestic trading desk. This directive informs the desk of the Committee's objective for "open market operations"—whether to ease, tighten or maintain the current policy. The desk then buys or sells U.S. government securities on the open market to achieve this objective.

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). 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. Sales of government securities do just the opposite—they shrink the reserve funds available to lend and tend to raise the funds rate.

By targeting the federal funds rate, the FOMC seeks to provide the monetary stimulus required to foster a healthy economy. After each FOMC meeting, the funds rate target is announced to the public.

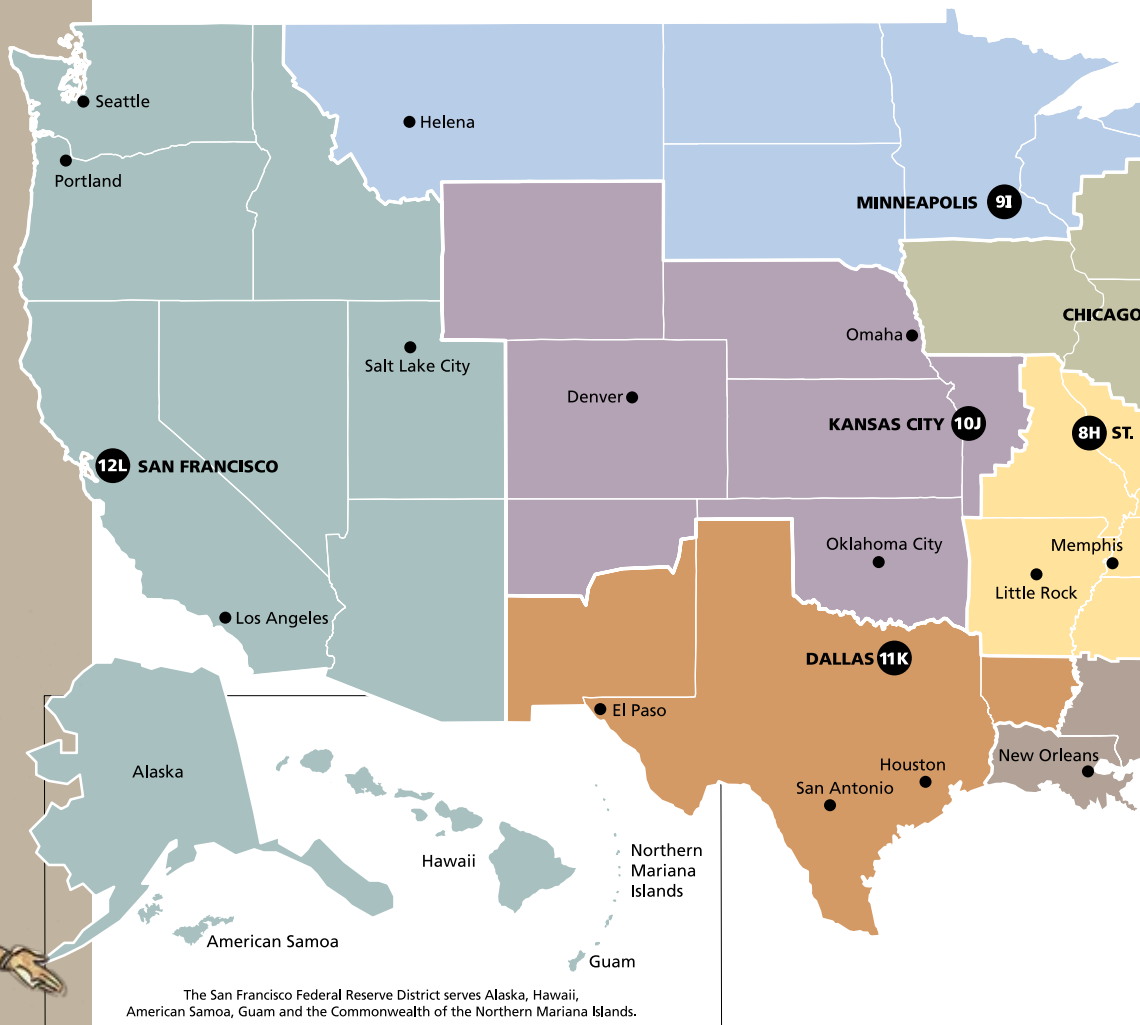
Still with us?

Great, you're halfway through! Now that you know who we are at the Federal Reserve—1) the Board of Governors, as the federal government agency; 2) the Reserve banks, as the operational arms; and 3) the FOMC, as the committee that sets monetary policy—let's move on to the “what we do” portion of the tour. (Is our main fold-out illustration starting to make sense yet?)

In the second half of this booklet, we'll walk through the activities of the Federal Reserve—looking primarily at those performed by regional Reserve banks—to see how we carry out the Fed's three main responsibilities: conducting monetary policy, supervising banks and providing financial services.



The Federal Reserve System's centralized component, the Board of Governors, is located in Washington, D.C. (See star on map.) Its decentralized components, Reserve banks, are scattered throughout the country. Listed at the bottom of the page are the 12 Reserve banks and their branches.



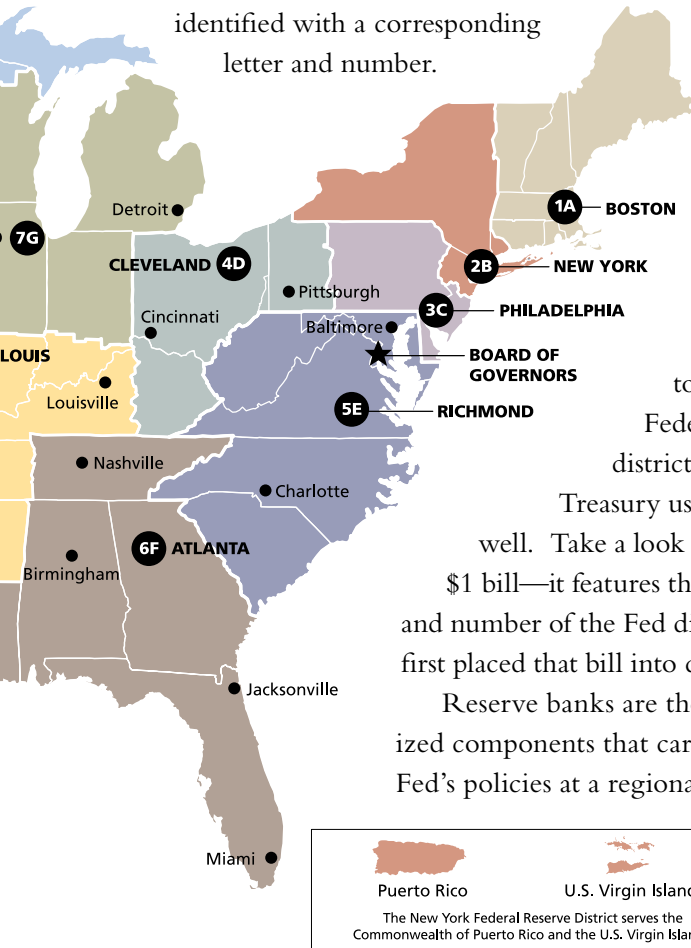
TWELVE RESERVE BANKS AND THEIR BRANCHES

1 BOSTON	2 NEW YORK	3 PHILADELPHIA	4 CLEVELAND Cincinnati Pittsburgh	5 RICHMOND Baltimore Charlotte
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The Big Picture

THE FED'S REGIONAL STRUCTURE

The map at left highlights the 12 Reserve banks and their 24 branch locations. Note that each bank is identified with a corresponding letter and number.



We use this coding to identify Federal Reserve districts. The

Treasury uses it as well. Take a look at a U.S. \$1 bill—it features the letter and number of the Fed district that first placed that bill into circulation.

Reserve banks are the decentralized components that carry out the Fed's policies at a regional level.

Day to day, the banks execute the laws written by Congress and the regulatory policies written by the Board of Governors. The 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 have an effect on the national economy? The economist's proximity to the region and expertise about it can help policymakers who participate in FOMC discussions evaluate whether regional pockets of economic data skew the national picture or reflect it.

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 bankers 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 beauties of the Fed's decentralized structure.

Now, back to the tour and on to “what we do.”

12	11	10	9	8	7	6	5	4	3	2	1
SAN FRANCISCO	DALLAS	KANSAS CITY	MINNEAPOLIS	ST. LOUIS	CHICAGO	ATLANTA	PHILADELPHIA	CLEVELAND	PHILADELPHIA	NEW YORK	BOSTON
Los Angeles Portland Salt Lake City Seattle	El Paso Houston San Antonio	Denver Oklahoma City Omaha	Helena	Little Rock Louisville Memphis	Detroit	Birmingham Jacksonville Miami Nashville New Orleans	Baltimore	Pittsburgh	Cincinnati		

What We Do

CONDUCTING MONETARY POLICY

In Plain English:

The Federal Reserve manages the nation's money supply to keep inflation low and the economy growing at a sustainable rate.

One of the most important jobs of the Federal Reserve is to keep our economy healthy. It does this by managing the nation's system of money and credit—in other words, conducting monetary policy.

Experience has shown us that the economy performs well when inflation is low. When inflation is low—and is expected to remain low—interest rates are usually low as well. Such an environment fosters 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 and wisdom.

The ability to maintain a low inflation rate is a long-term measure of the Fed's success. To achieve this, the Fed sets a variety of intermediate targets, including monetary aggregates, reserve aggregates and interest rates, to gauge the impact of its policies on the economy.

The actions that the Fed takes today influence the economy and the inflation rate for some time to come. Consequently, policymakers must be forward-looking and must take pre-emptive action to head off inflation before it gathers momentum.

HOW MONETARY POLICY WORKS

The Fed can use three tools to carry out 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 banks for short-term loans. 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 reserve, either in their vaults or on deposit at a Reserve bank. The Board of Governors has sole authority over changes to reserve requirements. By far, the most frequently used tool is open market operations, which involve 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. We'll have to get technical to explain how this works.

After each FOMC meeting, the Committee issues a directive to the domestic trading desk at the New York Fed. (See page 7.) This directive reflects the Committee's policy goals: easing, tightening or maintaining the

What We Do

SUPERVISING AND REGULATING BANKS

In Plain English:

The Federal Reserve writes regulations and supervises banks to ensure that the banking system is safe, sound and able to respond to a financial crisis.

One of Congress' paramount concerns in creating the Federal Reserve was to address the nation's banking panics. This need 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 gave the Fed responsibility to regulate the banking system and to supervise certain types of financial institutions. What's the difference between these two responsibilities? Bank *regulation* refers to the written rules that define what acceptable behavior is for financial institutions. The Board of Governors carries out this responsibility. 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 international organizations that do banking business in the United States. The Federal Deposit Insurance Corp. (FDIC), the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) also supervise financial institutions.

For the Fed, supervising banks generally means carrying out three duties: establishing safe and sound

banking practices, protecting consumers in financial transactions and ensuring the stability of U.S. financial markets by lending funds through its discount window. The goal of these duties is to minimize risk in the banking system.

SAFETY AND SOUNDNESS

The 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 risk.

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; they 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 risk. By looking at the bank's risk-management procedures and internal controls, Reserve bank examiners assess whether a bank's ability

to manage risk matches the level of risk it assumes. 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 exhibits weaknesses that require corrective action and close monitoring. Between examinations, Reserve banks monitor financial institutions by examining reports filed with the Fed.

Another way the Federal Reserve helps keep the banking system safe and sound is by reviewing major changes in a bank's structure or service offerings. When a bank wishes to expand, merge with another bank, acquire another bank or introduce new products, it must first get permission from the Federal Reserve. Reserve banks have two objectives when evaluating any application: ensuring that the resulting organization or product will be safe and sound, and maintaining competition in the regional banking market.

CONSUMER PROTECTION

Another Fed goal is to protect consumers in lending and deposit transactions. Congress has given the Fed

broad power to make, interpret and enforce laws that protect consumers from lending discrimination and inaccurate disclosure of credit costs or interest rates.

Fed examiners specially trained in consumer compliance laws examine banks for their adherence to such regulations. In their Community Affairs departments, Federal Reserve banks also take active roles in helping institutions broaden access to capital and credit by hosting forums and bringing together lenders, government agencies and community development groups.



DISCOUNT WINDOW LENDING

One of the most important ways that the Fed ensures safety and soundness of the banking system is by offering funds for loan through its discount window. 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. Typically, the Fed makes loans to satisfy banks' unanticipated needs for short-term funds. But the Fed also makes longer-term loans to help banks manage seasonal fluctuations in their customers' deposit or credit demands. The discount window was once used only to provide emergency funds from the "lender of last resort." Today, the discount window is often used to provide back-up funding to generally sound institutions.

What We Do

PROVIDING FINANCIAL SERVICES

In Plain English:

The Federal Reserve offers financial services to banks and the U.S. government to foster competition, innovation and efficiency in the marketplace.

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 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. Hand in hand with that mission is the obligation to improve the payments system by encouraging the use of efficient procedures and technology.

Essentially, a Reserve bank serves as a bankers' bank, offering a wide variety of financial services. It distributes currency and coin, processes checks and offers electronic forms of payment. The Fed competes with the private sector in its financial services to foster competition in the marketplace and promote innovation and efficiency in the payments system. The Fed does not seek to make a profit from its participation; it sets prices only to recover costs.

TRADITIONAL FORMS OF PAYMENT

Regional Reserve banks are responsible for meeting public demand for currency and coin within their

districts. The Reserve banks' primary responsibility in providing this service is to ensure that fluctuations in the demand for currency and coin do not disrupt the banking industry. Reserve banks process and store currency and coins for financial institutions.

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, like checks, with electronic forms of payment, which offer lower risk and higher efficiency to the payments system. In keeping with this goal, the Fed pursued several electronic initiatives in check processing that take advantage of image technology, which scans checks as they pass through high-speed sorting equipment and captures their images in electronic form for processing.

In 2004, federal legislation expanded the use of this technology, as well as the use of electronic deposit and presentment products, by making it possible for financial institutions to exchange electronic images of checks for settlement purposes. The result of this legislation streamlined settlement and transportation of paper

checks across the country, making check processing faster and more efficient.

Today, the Fed processes approximately 8.5 to 9.5 billion check transactions annually. 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. In fact, in 2003, the volume of electronic payments exceeded paper checks for the first time as a percentage of U.S. non-cash payments. The Reserve banks provide two electronic payment services: funds transfer and the automated clearing house, 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 are originated and 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 of the transactions sent over Fedwire are bank-to-bank transfers of funds, made on behalf of bank customers.

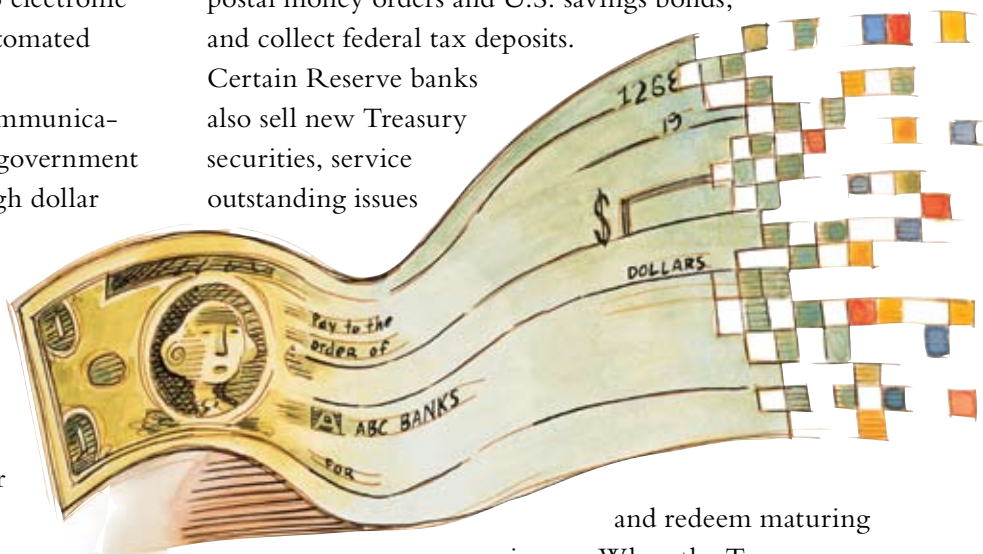
The ACH provides a nationwide network to exchange paperless payments among financial institutions and government agencies. The ACH accommodates a wide range of recurring corporate and consumer transactions, such as payroll deposit, electronic bill payment, insurance payments and Social Security disbursements.

Meanwhile, other forms of electronic payment—like smart cards, debit cards and Internet payment—are quickly becoming consumer staples. While the Fed does not directly provide these services, it is involved in the research and development of universal standards to ensure safety, convenience and accessibility.

THE FED AS FISCAL AGENT

In addition to serving as the bankers' bank, the Federal Reserve System acts as banker 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.

Certain Reserve banks also sell new Treasury securities, service outstanding issues



and redeem maturing issues. When the Treasury offers new issues of marketable securities to the public, certain Reserve banks disseminate information about the issues, process orders from customers, collect payments, credit the Treasury's account for the proceeds and deliver the securities.

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

[®] Fedwire is a registered trademark of the Federal Reserve banks.

A SUMMARY

For the past several pages, we have introduced you to who we are at the Federal Reserve—the Board of Governors, the 12 Reserve banks and the FOMC—as well as to what we do.

We have also described our three main responsibilities—conducting monetary policy, supervising banks and providing financial services. We hope we have helped you make sense of the complex, yet effective, function of the Federal Reserve System.

What becomes apparent is not only how important our functions are but just how effective our structure is in fulfilling the purposes of the Federal Reserve System.

It was a financial crisis that led to our creation, 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.

FEDERAL RESERVE WEB ADDRESSES

Board of Governors.....	www.federalreserve.gov
Federal Reserve Bank of Atlanta.....	www.frbatlanta.org
Federal Reserve Bank of Boston.....	www.bos.frb.org
Federal Reserve Bank of Chicago.....	www.chicagofed.org
Federal Reserve Bank of Cleveland.....	www.clevelandfed.org
Federal Reserve Bank of Dallas.....	www.dallasfed.org
Federal Reserve Bank of Kansas City.....	www.kansascityfed.org
Federal Reserve Bank of Minneapolis.....	www.minneapolisfed.org
Federal Reserve Bank of New York.....	www.newyorkfed.org
Federal Reserve Bank of Philadelphia.....	www.philadelphiafed.org
Federal Reserve Bank of Richmond.....	www.richmondfed.org
Federal Reserve Bank of San Francisco.....	www.frbsf.org
Federal Reserve Bank of St. Louis.....	www.stlouisfed.org

FEDERAL RESERVE PHONE NUMBERS

Board of Governors.....	202-452-3000
FRB Atlanta.....	404-498-8500
FRB Boston.....	617-973-3000
FRB Chicago.....	312-322-5322
FRB Cleveland.....	216-579-2000
FRB Dallas.....	214-922-6000
FRB Kansas City.....	816-881-2000
FRB Minneapolis.....	612-204-5000
FRB New York.....	212-720-5000
FRB Philadelphia.....	215-574-6000
FRB Richmond.....	804-697-8000
FRB San Francisco.....	415-974-2000
FRB St. Louis.....	314-444-8444

ADDITIONAL RESOURCES

In Plain English: A Virtual Tour is a 14-minute animated presentation of this booklet's main concept. It is available in DVD format, free of charge, at www.FederalReserveEducation.org. Through this site, you can also download an electronic (.pdf) version of the *In Plain English* booklet, order extra booklets or take the entire tour online. In addition, you can find bonus activities that test basic Fed knowledge in fun, puzzle-like formats that you can print directly from your

computer. (For questions on *In Plain English* materials or for ordering assistance, call the Public Affairs department at the Federal Reserve Bank of St. Louis at 1-800-333-0810, ext. 44-8560.)

FederalReserveEducation.org also contains many other web-based educational resources, such as FED101, an interactive web site on the Federal Reserve System.

In Plain English is published by the Federal Reserve Bank of St. Louis on behalf of the Federal Reserve System.

Can You Answer These In Plain English?

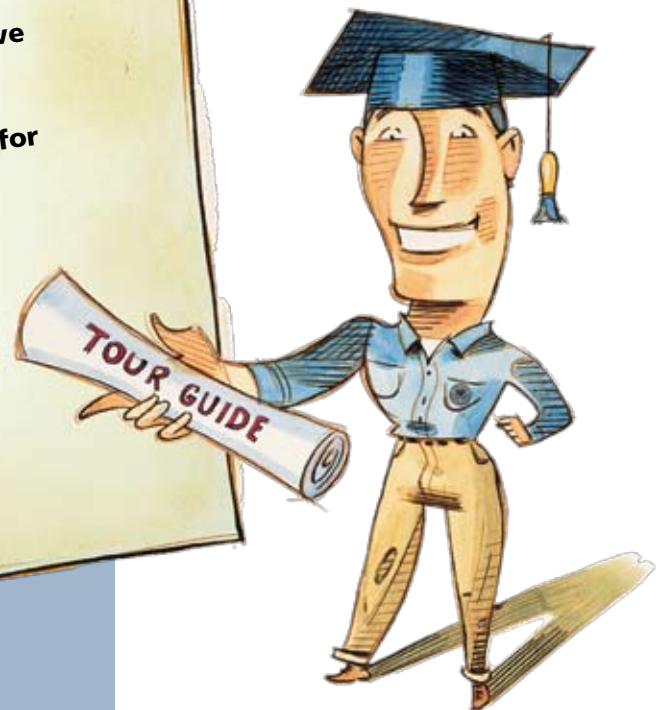
1. **Who created the Federal Reserve System?**
(page 1)
2. **Name the three parts of the Federal Reserve System.** (page 1)
3. **What is the name of the Fed's chief monetary policymaking body?** (page 7)
4. **How many districts make up the Federal Reserve System?** (page 9)
5. **In which Federal Reserve district do you live?**
(pages 8-9)
6. **What are the three responsibilities of the Federal Reserve System?** (page 8)
7. **Name three activities you might see at Reserve banks.** (pages 10-15)
8. **What is the Fed's most frequently used tool for conducting monetary policy?** (page 10)
9. **How does banking supervision differ from banking regulation?** (page 12)
10. **Name three financial services the Fed offers.** (pages 14-15)

Testing ... one, two

We hope you can now make sense of the Federal Reserve. So let's see if we've done our job by testing your newly acquired knowledge. If we stump you, refer to the page numbers in parentheses, where you can turn for the answer.

Good luck!

*Congrats,
you made it!*



*I'm outta here!
you take the
next tour!*

