Board of Governors of the Federal Reserve System

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FEDERAL RESERVE: THE NATION'S CENTRAL BANK

The Federal Reserve System is the central bank of the United States. It was founded by Congress to provide the nation with a safer, more flexible, and more stable monetary and financial system; over the years, its role in banking and the economy has expanded.

Today the Federal Reserve's duties fall into three general areas:

C Conducting the nation's monetary policy by influencing money and credit conditions in the economy in pursuit of maximum employment and stable prices.

C Supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking system, maintaining the stability of the financial system and containing systemic risk that may arise in financial markets, protecting the credit rights of consumers, and encouraging banks to meet the credit needs of consumers, including those in low and moderate income neighborhoods.

C Providing certain financial services to the U.S. government, to the public, to financial institutions, and to foreign official institutions, including playing a major role in operating the nation's payments system.

The Federal Reserve System was created by passage of the Federal Reserve Act, which President Woodrow Wilson signed into law on December 23, 1913. The Act stated that its purposes were "to provide for the establishment of Federal Reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes."

Soon after the creation of the Federal Reserve, it became clear that Act had broader implications for national economic and financial policy. As time has passed, further legislation has clarified and supplemented the original purposes. Key laws affecting the Federal Reserve have been the Banking Act of 1935; the Employment Act of 1946; the 1970 amendments to the Bank Holding Company Act; the International Banking Act of 1978; the Full Employment and Balanced Growth Act of 1978; the Depository Institutions Deregulation and Monetary Control Act of 1980; the Financial Institutions Reform, Recovery, and Enforcement Act of 1989; and the Federal Deposit Insurance Corporation Improvement Act of 1991. Congress defined the primary objectives of national economic policy in two of these acts: the Employment Act of 1946 and the Full Employment and Balanced Growth Act of 1978 (the latter sometimes called the Humphrey–Hawkins Act after its original sponsors). These objectives include economic growth in line with the economy's potential to expand; a high level of employment; stable prices (that is, stability in the purchasing power of the dollar); and moderate long-term interest rates.
Since the late 1960s, the number of federal laws intended to protect consumers in credit and other financial transactions has been growing. Congress has assigned the Federal Reserve the duty of implementing these laws to ensure that consumers receive comprehensive information and fair treatment. Thus, consumer protection laws such as the 1968 Truth in Lending Act, the Community Reinvestment Act of 1977, the Expedited Funds Availability Act of 1987, the Truth in Savings Act of 1991 and others have given the Federal Reserve rule-writing, compliance and consumer education responsibilities.

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

**Board of Governors**

The Board of Governors of the Federal Reserve System was established as a federal government agency. It is made up of seven members appointed by the President of the United States and confirmed by the U.S. Senate. The full term of a Board member is fourteen years; the appointments are staggered so that one term expires on January 31 of each even numbered year. The Chairman and the Vice Chairman of the Board are also appointed by the President and confirmed by the Senate. The nominees to these posts must already be members of the Board or must be simultaneously appointed to the Board. The terms for these positions are four years.

**Structure of the System**

The Federal Reserve System has a structure designed by Congress to give it a broad perspective on the economy and on economic activity in all parts of the nation. It is a federal system, composed basically of a central, governmental agency--the Board of Governors--in Washington, D.C., and twelve regional Federal Reserve Banks, located in major cities throughout the nation. These components share responsibility for supervising and regulating certain financial institutions and activities; for providing banking services to depository institutions and to the federal government; and for ensuring that consumers receive adequate information and fair treatment in their business with the banking system.
A major component of the System is the Federal Open Market Committee (FOMC), which is made up of the seven members of the Board of Governors, the president of the Federal Reserve Bank of New York, and presidents of four other Federal Reserve Banks, who serve on a rotating basis. The FOMC is charged under law with overseeing open market operations, the principal tool of national monetary policy. The FOMC also directs operations undertaken by the Federal Reserve in foreign exchange markets.
ACHIEVEMENT OF GOALS AND OBJECTIVES

The Board employs a comprehensive planning, budget formulation, and budget execution process to ensure the identification, prioritization, and accomplishment of goals and objectives. This process integrates strategic planning, allocation of resources among competing priorities, and ongoing reviews of the need for existing programs.

Background

In the face of accelerating change in the economy and banking system brought about by numerous factors, including globalization, technology, evolution of payments systems and bank consolidation, the Federal Reserve recently recognized the need for a more comprehensive planning framework. In 1995, a System Strategic Planning Coordinating Group was appointed, consisting of Board members, Reserve Bank Presidents and senior managers, representing the full range of the Federal Reserve's activities. This group produced an "umbrella" strategic framework under which the Board, the Reserve Banks and the product and support offices produce their own more detailed plans and decision documents. This framework is the basis for the Board's GPRA Planning Document, setting forth the mission, values, goals and objectives, key assumptions, and external and internal factors that could affect the achievement of those goals and objectives.

The System's strategic planning efforts recognize key differences between government and private sector strategic planning and measurement of results. Private planning can use measures of costs and revenue derived from prices determined in competitive markets; the results of that planning are reflected in the ability of the private entity to prosper over time. The government does not have direct competition in certain areas and has a monopoly in others (monetary policy, for example) and establishing a proxy for costs and prices is extraordinarily difficult. Moreover, the results are judged relative to public policy objectives embodied in law, which often are not readily measurable. Nonetheless, the government should try to effectively accomplish its mission while creating the efficiencies that come from strategic planning, recognizing that analogies are just that. Thus, the Board's central planning objective is oriented towards achieving effectiveness and efficiency specific to the functions we serve.

In monetary policy, for example, the System exerts only partial and indirect influence on the economy. Because the System's performance therefore cannot be measured solely in terms of economic outcomes, the appropriate judgement must be whether our research technology is successful in anticipating problems and changes in the economy. In the bank supervision function, the mission of contributing to a viable, competitive, efficient banking system demands a sharing of risks between the central bank and private banks, which serve the crucial function of managing the risk of investing in illiquid loans. As a regulator, our job is to ensure that banks are allowed to take on appropriate degrees of risk in fulfilling their function in the economy, but not to the point that they impose risks to the financial system in general. Measures of our success would include whether the banking system is performing its functions and whether systemic risk is appropriately
contained during periods of challenge to individual institutions or groups of institutions. In the payments area, where direct competition exists, the Federal Reserve is able to assess its performance in a more directly measurable way. However, unlike our competitors, the appropriate goal is not to maximize profits, but to enhance the efficiency and integrity of the nation's overall payment system while recovering costs, both direct and imputed. A delicate balancing of marketplace performance and mission-specific efficiency is required.

**Strategic Planning and the Budgeting Process**

In order to enhance the focus on strategic priorities, the Board has restructured its budget and planning process to lengthen the planning and budgeting horizons and involve the Board itself more heavily in setting priorities. The Board has adopted a four-year planning horizon and a two-year budget. The first biennial budget (1998/1999) will go into effect on January 1, 1998.

In developing plans and budgets under the strategic framework, the director of each Board division updates division-wide plans, coordinating their efforts with other directors and Reserve Banks as necessary. These plans and resulting resource requests are reviewed by the Board's Budget Committee, established in 1997 to formalize the high level review of budget plans and to make recommendations to the full Board. Currently, the Committee is chaired by Vice Chair Alice M. Rivlin, the Board's current Administrative Governor, and includes former Administrative Governors Edward W. Kelley and Susan M. Phillips. They are supported by a Staff Planning Group which advises the Budget Committee in the planning process by identifying issues and helping to evaluate the Board's budget options.

The Reserve Bank budget process provides a similar level of review and oversight for Reserve Bank budgets. That process is managed on an annual basis and Reserve Bank budgets are considered by the Board following review by the Committee on Federal Reserve Bank Affairs.

**Board Staffing and Management**

The strategic planning exercise undertaken this spring and summer identified position reductions -- amounting to approximately 3.5 percent of staff -- which will be carried-out over the coming two-year budget cycle, with limited impact on the Board's ability to carry out its mission. For the 1998-1999 budget period, the Board will require approximately 1,700 employees and an operating budget of approximately $353 million. This level of support is required for the Board to carry out its responsibilities for promoting price stability and maximum employment, a sound financial environment, protection of consumers' financial rights, and an effective and efficient payment system.
Because of the complexity, scope and volume of its responsibilities, a highly qualified and trained staff is necessary to carry out the Board's mission. The Board has developed programs to provide the salary and benefits needed to compete in the market for a diverse, highly skilled workforce and training programs to maintain these skills in a dynamic financial and regulatory environment. The Board also requires the ability to gather, store, retrieve and manipulate large quantities of economic and financial data. This requires modern automation and telecommunications capabilities and a supporting infrastructure. The Board emphasizes the need to ensure that appropriate management and resources are devoted to maintain this infrastructure.

The Board is organized along division lines with specific functions. The divisions conducting the basic programs and activities of the Board are:

I Monetary Policy Function
The Division of Research and Statistics
The Division of Monetary Affairs
The Division of International Finance

II Supervision and Regulation Function
The Division of Banking Supervision and Regulation
The Division of Consumer and Community Affairs

III System Policy Direction and Oversight Function
The Division of Reserve Bank Operations and Payment Systems

The divisions in the first group are primarily concerned with the Board's monetary policy objectives, although a significant and growing level of activity in the Division of Research and Statistics supports the supervision and regulation and consumer protection work of the divisions in the second group. The Division of Reserve Bank Operations and Payment Systems is responsible for the oversight of Reserve Banks' provision of financial services to depository institutions and the U.S. government. The division also plays a major role in the development and implementation of policies, regulations, and services to enhance the efficiency and integrity of the U.S. dollar payments system.
MISSION

The mission of the Federal Reserve System is to foster the stability, integrity, and efficiency of the nation's monetary, financial, and payment systems so as to promote optimal macroeconomic performance.

VALUES

The values of the Federal Reserve, which guide its organizational decisions and its employees' actions, include:

- **Commitment to the public interest** -- The Federal Reserve endeavors to provide service to the public, the U.S. government, and the financial community that is consistent with its mandate. It expects to be held accountable to the public it serves.

- **Integrity** -- The Federal Reserve seeks to adhere to the highest standards of honesty, fairness, and discretion in its dealings with the public, the financial community, and its employees.

- **Quality and excellence** -- The Federal Reserve strives for excellence, embracing prudent change and innovation.

- **Independence of views and careful analysis** -- The Federal Reserve values the regional nature of the System as well as the diversity of its employees; input from a variety of sources; independent professional judgment; thorough and careful analysis; and the integration of these components through teamwork into coherent, effective policies.

GOALS

The Federal Reserve has three primary goals with interrelated and mutually reinforcing elements:

1) To conduct monetary policy toward the achievement of maximum sustainable long-term growth; price stability fosters that goal.

2) To promote a safe, sound, competitive, and accessible banking system and stable financial markets through supervision and regulation of the nation's banking and financial systems, through its function as the lender of last resort, and through effective implementation of statutes designed to inform and protect the consumer.

3) To foster the integrity, efficiency, and accessibility of U.S. dollar payment and settlement systems, issue currency, and act as the fiscal agent and depository of the U.S. government.
MONETARY POLICY FUNCTION

GOAL: Conduct monetary policy that promotes the achievement of maximum sustainable long-term growth; price stability fosters that goal.

Objective 1: Continue to perform high quality analysis of macroeconomic and financial developments and develop accurate forecasts for making appropriate policy decisions.

Discussion

The Federal Reserve Board and Federal Open Market Committee (FOMC) make decisions on the stance of monetary policy on the basis of thorough analyses of recent macroeconomic developments, forecasts, and evaluations of the likely effects of alternative policy choices on the attainment of its policy goal. To make appropriate policy judgments, the Board, FOMC, and their staffs monitor and analyze a broad range and extremely large volume of economic and financial intelligence, including anecdotal information, statistical series, and cross-sectional survey data. Staff produces analyses, reports and data needed to support policy decisions affecting open market operations by the FOMC. Such decisions are generally made at regular meetings held approximately every eight weeks. The Board makes periodic decisions on the discount rate and occasional changes in reserve requirements. Public explanations of monetary policy decisions are made in the announcement of policy changes by the FOMC, the publication of minutes of FOMC meetings, congressional testimony, and the publication of semi-annual monetary policy (Humphrey-Hawkins) reports.

Objective 2: Effectively assess the implications of advancing technologies, financial innovation and deregulation, and globalization for macroeconomic developments and monetary policy.

Discussion

The U.S. economy and financial system are evolving rapidly in response to a variety of factors. These changes have the potential to alter significantly the interactions among economic variables and hence the way in which monetary policy influences the economy, for example by amplifying or damping responses or by changing the lags between policy action and aggregate spending and inflation. Key to the Federal Reserve's ability to formulate appropriate policy will be its effectiveness in analyzing the implications of these developments for monetary...
policy. The Board's research functions will be putting added emphasis identifying and analyzing new developments for consideration by monetary policy makers. The Board strives to enhance its analyses of economic developments to promote the ability of the Federal Reserve and other policy makers to contribute to meeting national economic goals. To communicate these analyses, reports, papers, and public statements are provided regularly to Congress, the Administration, and the public.

**Objective 3:** Effective implementation of monetary policy in an evolving financial environment.

**Discussion**

The Federal Reserve implements monetary policy primarily by affecting conditions in markets for bank reserves through open market operations. In recent years, depository institutions have reduced their required reserve balances sharply through "retail sweep programs." Previous experience suggests that the decline in required reserve balances could, at some point, significantly complicate the implementation of monetary policy. The incentive for depository institutions to conduct these sweeps would be essentially eliminated if Congress authorized the payment of interest on reserve balances. In the absence of such statutory authority, the Federal Reserve may need to adapt its procedures to permit the continued smooth implementation of monetary policy.

**Objective 4:** Play a leadership role in the development of international policies and procedures related to the System's mission, in cooperation with other agencies and the Treasury when appropriate, in order to reduce risks to the U.S. economy and banking system from external shocks and to improve stability in domestic and international financial markets.

**Discussion**

Board staff provides the Board, FOMC, and other System officials with assessments of current and prospective international economic and financial developments. Staff members also evaluate and forecast major economic and financial developments abroad, developments in foreign exchange markets, other international asset markets and U.S. international transactions. Analysis of international banking activities is an ongoing activity that supports this objective.
**External Factors:**

**Independence** -- The Federal Reserve's independence within the government, a key element of which is its lack of dependence on the appropriations process, is critical in terms of its ability to formulate and implement monetary policy. Preserving this independence will be crucial to the proper discharge of its central banking responsibilities in the future. This independence depends importantly on responsible management of the resources used. Along these lines, the Board will continue to operate under both internal and external pressures for budget restraint, even as it performs its current and any expanded future responsibilities.

**Sweep Accounts** -- The Federal Reserve implements monetary policy primarily by affecting conditions in markets for bank reserves through open market operations. In recent years, depository institutions have reduced their required reserve balances sharply through "retail sweep programs." Previous experience suggests that the decline in required reserve balances at some point could significantly complicate the implementation of monetary policy. The incentive for depository institutions to conduct these sweeps would be essentially eliminated if Congress authorized the payment of interest on reserve balances.

**Economic and financial globalization** -- Individual economies are becoming more open and links among the world's financial markets are becoming closer. These forces heighten the potential for economic shocks and systemic problems to move across national borders, in some circumstances, with great speed. As a result, there will be pressure for greater international consistency of policies, regulations, guidelines, and supervisory procedures.

**Legislative Changes:** Authorization by Congress to pay interest on reserve balances would help ensure an adequate level of reserve balances and thus promote the continued smooth implementation of monetary policy.

**Performance Measures:** The Congress has not chosen to establish quantitative objectives for monetary policy in statute. Moreover, it is recognized that monetary policy has only a partial and indirect influence on economic performance. The performance of monetary policy in relation to evolving economic and financial circumstances will continue to be reviewed by the Congress in the context of the Board's semiannual monetary policy report and the accompanying testimony.
BANKING SUPERVISION AND REGULATION FUNCTION

GOAL: Promote a safe, sound, competitive, and accessible banking system and stable financial markets through supervision and regulation of the nation's banking and financial systems; through its function as the lender of last resort; and through effective implementation of statutes designed to inform and protect the consumer.

Objective 1: Provide comprehensive and effective supervision of U.S. banks, bank holding companies, foreign banking organizations and related entities by focusing supervisory efforts on areas of highest risk to individual organizations and the financial system as a whole.

Discussion

As described in the Federal Reserve Act, a fundamental responsibility of the central bank is to establish more effective supervision of banking in the United States. Supervisors may undertake many preventative measures during stable periods of economic expansion to ensure the safety and soundness of the banking system. However, to meaningfully measure whether past and current supervisory practices are effective, the performance and stability of the banking system should be evaluated over a full economic cycle that reveals its soundness and resiliency under stressful conditions.

One of the Federal Reserve's key strategies for maintaining effective supervision under both favorable and unfavorable banking conditions has been the incorporation of a risk-focused approach in the supervisory process. The risk-focused approach emphasizes pre-examination planning and prioritizes examination resources based on an organization's risk profile. Significantly, this approach also places greater emphasis on evaluating the integrity of an institution's own ongoing system for managing risk, rather than point-in-time transaction testing. By focusing resources on the areas of highest risk and eliminating unnecessary procedures and resources, this approach is not only more effective, but also results in a less burdensome form of oversight while accomplishing the secondary goal of reducing costs for the financial institution and the Federal Reserve. In addition, the pre-examination planning is more comprehensive by integrating information from various functions of the Federal Reserve. The risk-focused approach has been advanced throughout the System and in coordination with other banking regulators. More formal supervisory programs to implement the risk-focused approach in a consistent fashion across the System for community banks and large, complex banking organizations are underway. The work, particularly the development of necessary automation tools, is being coordinated with the OCC and FDIC.
Objective 2: Promote sound practices for managing risk at banking organizations that provide for strong internal controls, active boards of directors, and senior management oversight and accountability.

Discussion

Recognizing that capital requirements cannot substitute for effective risk management and internal controls in financial institutions, the Federal Reserve, along with other international and domestic supervisors, has placed increasing emphasis on risk management practices. This focus has resulted in a series of instructions, policy statements, and examination manuals which stress the importance of managing all risks inherent in the business of banking, including market and credit risks, liquidity, legal, international, and operational risks.

At the core of this focus are four basic elements of sound risk management: 1) active oversight roles by bank boards of directors and senior management; 2) adequate policies, limits, and procedures; 3) adequate risk measurement, monitoring, and management information systems; and, 4) adequate internal controls and audits. Internal controls are receiving increased attention because breakdowns, or absences of controls, have been key to most of the recent financial problems encountered by large financial institutions.

In recent years, sound practice guidance for examiners and financial institutions has covered trading activities, nontrading securities and derivative end-user activities, interest rate risk, private banking, and secondary market credit activities, among others. The dissemination of this guidance has clarified our expectations for the institutions we supervise, improved the quality of examinations in these areas, and led to improved practices by many institutions.

To address the evaluation of risk measurement and management in their evaluations of institutions, U.S. banking supervisors have introduced a new composite "S" to the CAMEL rating system. The "S" of the new CAMELS system represents a measurement of the market risk (price and interest rate), or risk sensitivity, an evaluation of the effectiveness of an institution's risk management practices relative to that risk, and assessment of the risk relative to capital. (CAMEL stands for capital, asset quality, management, earnings, and liquidity.) Furthermore, the Federal Reserve has incorporated a separate evaluation of the quality of an institution's risk management as an "R" subcomponent of the M or management component. Similarly, the R in ROCA, the Federal Reserve's rating system for U.S. branches and agencies of foreign banks, represents an evaluation of risk management. (ROCA stands for risk management, operational controls, compliance and asset quality.)
Objective 3: Promote sound banking and effective supervisory practices among developed and emerging countries through ongoing coordination with international supervisory bodies and through training programs for international supervisors and bankers.

Discussion

The Federal Reserve continues to work with other supervisory bodies through the Bank of International Settlements (BIS) to promote standards for consolidated supervision and to broaden the scope of coordination to include supervision of securities and other non-bank activities. Through the BIS, the Federal Reserve also works to promote sound risk management practices, capital standards and improved disclosures by banking organizations. In addition to these BIS initiatives, other international efforts include work through the so-called Joint Forum (which consists of representatives from the banking, securities, and insurance regulatory communities of countries throughout the world). Through the Joint Forum, the Federal Reserve is addressing supervisory information sharing as well as supervisory techniques for analyzing the soundness of financial conglomerates.

The Federal Reserve is also responding to training requests by bank supervisors of countries with young or emerging banking systems. These training programs directed at the supervisory staff of these countries are key to efforts to ensure international adoption of sound banking practices and adequate consolidated supervision of international banking organizations.

Objective 4: Maintain ability and capacity as a bank supervisor and central bank to ensure that emerging financial crises can be identified early and successfully resolved.

Discussion

Critical to its central banking mission of promoting overall financial stability is the knowledge, skills and hands on experience the Federal Reserve acquires through its bank supervisory function. Having a solid understanding of bank exposures, risk management techniques, operating strategies, and financial strengths and weaknesses, both for individual institutions and for the financial system as a whole, is critical to responding rapidly and effectively to systemic problems. Also key to maintaining the central bank's effectiveness are examiners who have the necessary authority, skills, automation support, and experience to gather facts and reach informed judgments.

The Federal Reserve's current supervisory responsibilities have allowed its staff to acquire the knowledge, skills and experience necessary to meet its role as crisis
manager. However, rapidly changing technology, new financial instruments and evolving markets have increased the complexity of evaluating the financial system and the requisite level of education and training of the Federal Reserve’s professional staff. Retaining knowledgeable workers and specialists that accumulate practical supervisory experience has been especially challenging in recent years, as the Federal Reserve must compete with private firms with significantly greater compensation to offer. In the past several years, turnover has grown, especially among those with certain specialized skills in automation and capital markets. In the future, maintaining a competitive and flexible compensation program will be essential to remain responsive to financial innovation and the changing structure of the industry.

**Objective 5:** Maintain an understanding of the effect of financial innovation and technology (e.g. new powers and products, new risk management and measurement methodologies, and electronic banking) on the operations and risk profile of banking organizations and the payment system, and ensure that supervisory programs accommodate prudent advances that benefit consumers and businesses or improve risk management.

**Discussion**

Dramatic advances in information and telecommunication technologies have allowed banks to develop new and improved products and services and to deliver them over a broader geographic area with greater efficiency. Such innovations by the banking industry and by financial markets in general, have increased the sophistication and complexity of bank lending, investing, trading, and funding. They have propelled growth in less traditional or newer fee-oriented banking activities, and in the process, altered the risk profiles of many banking organizations in fundamental ways.

Significantly, these activities have placed greater pressure on management to adequately monitor and manage the inherent credit, market, liquidity, reputational, operational and legal risks of their operations. While these newer activities pose the same risks posed by traditional banking, in many cases they present themselves in more complex and less transparent ways, making them more difficult to identify and analyze.

A material challenge for supervisors is to identify those activities that warrant a supervisory response in terms of sound practice guidance, interpretations, or new rulemakings to safeguard banks and the payment system. At the same time, regulators must ensure that supervisory responses provide a balance between allowing prudent risk taking by banking organizations and safeguards against
excessive practices. An example of a balanced supervisory response to financial innovation is the implementation of the market risk rule for the trading activities of large banking organizations. That rule requires banks to hold capital commensurate with the market risk of their trading activities, while allowing them to use their own "value-at-risk" models, rather than a rigid supervisory formula, to calculate their capital requirement. To succeed in endeavors such as this, the Federal Reserve must employ qualified and experienced staff in various specialties and provide them with ongoing hands-on experience and training.

Objective 6: Heighten the positive effect of market discipline on banking organizations by encouraging improved disclosures, accounting standards, risk measurement and overall market transparency.

Discussion

While the first line of defense for supervisors is the integrity of an institution's own system for managing risk, another significant force that may be harnessed for promoting safety and soundness is market discipline. The use of relevant accounting, financial and management disclosures to the marketplace has placed strong pressure on bank management to act prudently in their operations or be quickly punished through declining stock prices or higher financing costs. Although regulatory authorities have various powers and authority to influence management behavior, the strong incentives of the marketplace may often make such supervisory intervention unnecessary. However, harnessing the force of market discipline to promote financial stability requires the promotion of new and better disclosures to allow the marketplace to evaluate an institution's performance on a timely basis. This is an especially challenging area for authorities and the marketplace as disclosures that effectively communicate the underlying value and risk related to the industry's ever more complex activities are more difficult to design and implement. The Federal Reserve has worked in the past to heighten the effect of market discipline through coordination of various initiatives with the SEC, FASB, AICPA, IASC, the BIS and other domestic bank regulators. The Federal Reserve remains committed to achieving progress in this area to ensure that incentives for sound banking practices are maximized.

Objective 7: Harness benefits of technology in carrying out responsibilities to improve supervisory efficiency and reduce burden on banking organizations.

Discussion

The Federal Reserve is in the process of adapting technology to more fully
automate the examination process and improve communication across the System and among state and federal regulators. Automating examination efforts should assist in the Federal Reserve's efforts to be less intrusive while improving effectiveness. The development of examiner work stations, one tailored to the distinct needs of small banks and another for large, complex banking organizations, should help reduce the time and effort spent on site collecting and analyzing examination data and speed the documentation of work and the production of exam reports. Advances in workstation technology will also allow the use of statistical techniques for sampling loan portfolios, which should reduce burden on the institution while improving the effectiveness of the loan review. The workstations will also allow for a more sophisticated review of the risk profile of the institution using both regulatory and internal data from the institution.

Significantly, workstation technology is also expected to improve communication by allowing analysts and examiners throughout the System to work more closely together and share information on domestic and foreign banking organizations. In this way, remote events and supervisory activities can be viewed together to ensure a more consistent and global approach to supervision. In addition, the use of the Internet and the creation of an intranet to facilitate internal web sites have introduced new ways of accessing a wealth of valuable information. Efforts toward better communication and cooperation on automation initiatives between regulatory agencies continue to make the best use of collective resources. In an effort to make the best use of available technology, centralized product offices are being established throughout the System to provide better consistency and communication. In our rapidly changing environment, the Federal Reserve is committed to evaluating new technologies that can enhance our supervision of financial institutions.

**Objective 8:** Assure fair access to financial services for all Americans through vigorous enforcement of the Equal Credit Opportunity, Fair Housing, Community Reinvestment and Home Mortgage Disclosure Acts and by encouraging state member bank involvement in community development activities.

**Discussion**

The Federal Reserve administers the regulations that apply to all lenders subject to the Equal Credit Opportunity and Home Mortgage Disclosure (HMDA) Acts and enforces these laws, as well as the Fair Housing and Community Reinvestment Acts (CRA), in its examination of state member banks. It must also consider CRA performance on the part of banks and bank holding companies when they apply for approval for bank mergers and acquisitions. It investigates consumer complaints alleging discrimination and supports a wide range of activities designed to prompt banks to engage in community development lending. Through examining banks
under CRA to assure that they are not overlooking low and moderate income areas, assessing their performance in connection with applications for expansion, and encouraging and educating them about successful outreach programs, the Federal Reserve works to help make sure that all citizens are provided access to banking services.

**Objective 9:** Administer and ensure compliance with consumer protection statutes relating to consumer financial transactions (e.g. Truth in Lending, Truth in Savings, Consumer Leasing, and Electronic Funds Transfer) to carry out Congressional intent, striking the proper balance between protection of consumers and burden to the industry.

**Discussion**

The Federal Reserve is charged with writing the regulations implementing a wide range of consumer protections for financial transactions, including borrowing and savings disclosures, limits on liability for lost or stolen credit and debit cards, resolving errors in credit and debit transactions, and protections against abusive practices. These rules apply to all institutions serving customers, whether banks, finance companies, mortgage brokers, retailers or others. To be effective, the rules must be updated and interpreted to take account of changing business practices, and augmented by effective consumer education.

**External Factors:**

**Economic performance** -- During periodic downturns, the number of financial institutions requiring close supervision will increase. Systemic risk will increase resulting in more frequent monitoring of state member banks and bank holding companies.

**Legislative and statutory initiatives** -- Possible changes in long-standing legislative mandates, such as those affecting the artificial barriers between commercial and investment banking or the limitations on commercial banking activities, will have a profound impact on supervision and regulation activities. Passage of a financial modernization bill may affect significantly the mission and organization of the Board.

**Industry consolidation** -- Continued integration of U.S. financial market sectors, accompanied by the introduction of new financial products and means for their delivery, is further blurring lines between banks and non-banks. Securities firms, insurance companies, financial companies, and even many prominent industrial companies -- as well as commercial banks -- are exploiting technological and financial innovations to seek to capture larger shares of the financial services market. Industry consolidation is having an impact on the way the Board operates
to ensure safety and soundness and limit systemic risk.

**Technology** -- The rapid pace of technological innovation, especially in telecommunications and electronic data processing, is having a profound effect on the economy and on U.S. financial services. The harnessing of technology will be central in the development of new financial services and channels of distribution in the private sector. Technology will likely pose challenges in all of the Federal Reserve's policy areas, including banking supervision and regulation and consumer protections. Technological innovation will also create opportunities by providing tools to improve the Board's efficiency across organizational units and functions.

**Privatization and Demographic Changes** -- In an era of shrinking government -- with the emphasis on cost reduction and privatization of public functions -- the traditional government "safety net" will always not be available. But the underlying social problems will remain. Pressure will be increased on acceptance of "social responsibility" by the private sector, including banks. Changing demographics could further heighten interest in civil rights and fair lending matters.

**Economic and financial globalization** -- Individual economies are becoming more open and links among the world's financial markets are becoming closer. These forces heighten the potential for economic shocks and systemic problems to move across national borders, in some circumstances with great speed. As a result, there will be pressure for greater international consistency of policies, regulations, guidelines, and supervisory procedures.

**Pressure to reduce regulatory burden** -- There will be continuing pressure on the Board from markets, banking and other financial institutions, the general public, and the Congress, to reduce regulatory burden and improve efficiency. This has and will continue to require streamlining of regulations and automating and standardizing examination processes.

**Century Date Compliance of Information Systems** -- The inability of most computer programs to distinguish the year 1900 from the year 2000 poses substantial risks to all financial institutions. The Federal Reserve is involved in an interagency effort to promote early remediation and testing by the industry. The Federal Reserve will examine every bank subject to its jurisdiction by mid-1998 and will review their progress as part of all examinations conducted throughout the remaining months of the millennium.
During 1997, the Board approved a major realignment of supervision staff to fulfill better the Federal Reserve's chief supervisory responsibilities. The new organizational structure will improve coordination and consistency of supervision, particularly in regard to supervision of global financial institutions. The realignment will also improve utilization of information technology by establishing a management structure that minimizes duplication and inconsistency through the system. The reorganization will further reduce staffing levels, allocate resources to better reflect changing priorities, strengthen management, and better utilize staff with strong managerial and technical skills.

1) Percentage of financial institution examinations completed as required by statute.

2) Net losses to the Bank Insurance Fund (BIF) from state member banks, consistent with economic conditions.

3) Extent to which the Federal Reserve, working alone or in cooperation with other authorities, is successful in identifying supervisory and/or financial problems in a timely manner and resolving them in a way that minimizes disruptions to the financial and payments systems and the economy more generally.

4) Percent of applications processed within Board-established timeframes.

5) Consumer affairs examinations conducted to ensure compliance with consumer protection laws and regulations.

6) Guidance issued to ensure compliance with consumer protection laws.
PAYMENTS SYSTEMS AND FINANCIAL SERVICES
FUNCTION

GOAL: Foster the integrity, efficiency, and accessibility of U.S. dollar payment and settlement systems, issue currency, and act as the fiscal agent and depository of the U.S. government.

Objective 1: Provide Federal Reserve Bank priced payment services that continue to maintain and improve the efficiency and integrity of the U.S. dollar payments mechanism.

Discussion

The Reserve Banks provide a broad array of priced payment services to depository institutions. These services include: Fedwire funds transfer, Fedwire book-entry transfer of federal agency securities, check clearing, automated clearing house (ACH), net settlement, noncash collection, and special cash services. The Federal Reserve continues to improve the quality and reduce the costs of these services, while providing a safe and sound basis for the U.S. payment and settlement systems.

The Monetary Control Act requires that, over the long run, the Federal Reserve set fees for its services to recover all direct and indirect costs of providing these services to depository institutions. The fees must be set to also recover certain imputed costs, such as taxes that would have been paid and return on capital that would have been provided, had the services been provided by a private firm. One of Congress’ objectives in adopting the Monetary Control Act was to promote a competitive environment for the provision of payment services in order to improve efficiency in the provision of those services.

A key strategy of the Federal Reserve to improve the efficiency and integrity of U.S. payments mechanisms is to provide payments services that reduce the operational barriers and risks faced by private-sector providers of payments services. In this regard, the Federal Reserve recently expanded the operating hours of its Fedwire funds transfer services from 10 hours per day to 18 hours per day. Expanded operating hours will remove an operational barrier to private-sector settlement initiatives, such as foreign exchange clearinghouses, that may reduce settlement risk in the foreign exchange markets, as well as eliminate obstacles to potentially important innovations in privately provided payments and settlement services. The Federal Reserve is also planning to implement enhanced net settlement services with same-day finality to serve better the needs of private-
sector clearing mechanisms in an interstate branch banking environment. Another key strategy of the Federal Reserve is to continue to attain cost efficiencies in the electronic payment services it provides to depository institutions while continuing to attain full cost recovery. These cost efficiencies will be reflected in lower fees charged by the Federal Reserve for those services.

Objective 2: Meet public demand for U.S. currency in the U.S. and abroad, work with Treasury to implement effective counterfeit-deterrence and detection features in U.S. currency, and provide for the smooth introduction of new-design currency.

Discussion

The U.S. dollar is the most widely used currency in the world. An estimated $430 billion in U.S. currency is in circulation, of which roughly 65 percent is held abroad. Interest on securities pledged to collateralize currency in circulation represents a significant source of income to the U.S. government.

The Federal Reserve fulfills its responsibility to provide an elastic currency by specifying the amount of new currency produced by the Treasury's Bureau of Engraving and Printing, accepting deposits of excess and unfit currency from depository institutions, and paying out currency to depository institutions to meet public demand. Automated systems are used to collect data to monitor the Reserve Banks' currency inventories and the availability of new currency at the Bureau of Engraving and Printing. Analyses of Reserve Bank inventory levels, currency destruction rates, and cash flows between Reserve Banks and depository institutions are used to forecast future demand for new currency.

While counterfeiting of U.S. currency is extremely rare relative to the volume of currency in circulation, the Federal Reserve and Treasury stay abreast of technological advancements available to potential counterfeitters and review and update U.S. currency design to make counterfeiting difficult. The Federal Reserve and Treasury continuously review data about counterfeiting to monitor trends in counterfeit activity. Foreign currency experts and industry specialists in covert technology are consulted regularly. The Federal Reserve also assists the Department of the Treasury in developing and presenting public education programs in many different languages about the new currency design.

The Federal Reserve's strategy to achieve this objective is for Reserve Banks to maintain sufficient supplies of high-quality currency to meet public demand, to work with Treasury to deter and detect counterfeiting of U.S. currency, and to introduce new-design currency without disrupting operations.
**Objective 3:** Provide efficient and effective fiscal agency and depository services on behalf of Treasury and other government agencies.

**Discussion**

As fiscal agents of the United States, Reserve Banks provide a broad range of debt-related services the Department of the Treasury. These services include issuing, exchanging, transferring/reissuing, and redeeming marketable Treasury securities and U.S. savings bonds, and processing secondary market transfers initiated by depository institutions. As depositories, Reserve Banks collect and disburse funds on behalf of the U.S. government. Reserve Banks also provide fiscal agency services on behalf of several domestic and international government agencies.

In 1996, Reserve Banks processed nine million Fedwire transfers of Treasury securities and handled more than 895 thousand tenders from commercial and individual investors to purchase government securities in Treasury auctions. The Reserve Banks also printed 55.1 million savings bonds and issued 2.7 million savings bond payments on behalf of Treasury. As depositories, the Reserve Banks processed 6.3 million advices of credit from depository institutions accepting tax deposits from businesses and individuals, processed 625 million ACH transactions for Treasury, and paid 436 million government checks.

Reserve Banks regularly develop reports detailing the cost, efficiency, and quality of fiscal agency and depository services. Correspondence, conversations with customers, and quality surveys are also used to monitor delivery of services.

The Federal Reserve will continue to support the Treasury and other government agencies by providing efficient and effective fiscal agency and depository services. Major efforts in this area include:

- Continuing to support expanded electronic tax collection.
- Successfully implementing new functions for TREASURY DIRECT securities investors: "Pay Direct" (debit ACH), "Sell Direct" (secondary market sales) and "Reinvest Direct" (telephone reinvestment).
- Implementing the new Series I Savings Bond.
- Supporting implementation of Treasury's EFT 99 initiative.
- Implementing full-cost accounting and reporting for fiscal and depository services.
**Objective 4:** Study and monitor U.S. dollar payment, clearing, and settlement systems and the risk issues pertaining to these systems to facilitate sound policy decisions that foster the integrity of the nation's payment systems.

**Discussion**

The Federal Reserve continuously analyzes payment, clearing, and settlement systems, as well as emerging forms of payments, in order to better understand interrelationships, changes, effects, and risks. Federal Reserve staff conducts high-quality analyses regarding the structure, efficiency, and integrity of U.S. dollar payment and settlement systems; developments and innovations in these systems; and the effects of the Board's policies on these systems. The Federal Reserve also conducts research on issues relating to the formulation and implementation of policies and regulations regarding payment and settlement systems, provides studies relating to the cost and scale efficiency of the Reserve Banks in the provision of financial services, and provides studies relating to the pricing of Federal Reserve services.

**External Factors:**

**Technological innovation** -- Technological innovation provides opportunities to improve materially the efficiency and integrity of the nation's payment system. The Federal Reserve has leveraged technological advances to reduce the cost of providing its financial services while improving their security and reliability, enhancing risk monitoring, speeding payments processing, and enhancing functionality. The Federal Reserve will continue to evaluate opportunities to use technological innovations to improve further its financial services.

**Interstate banking** -- The Federal Reserve is taking steps to facilitate interstate branch banking, which is now allowed nearly nationwide. Effective January 1998, the Federal Reserve will implement a new account structure to support account management and information needs for depository institutions that operate branches in multiple Federal Reserve districts. The Board has revised its regulations and the Reserve Banks are revising their operating circulars that govern their services and credit policies to support interstate branch banking. In addition, the Federal Reserve is implementing enhanced net settlement services with same-day finality to serve better the needs of private-sector clearing arrangements in an interstate branch banking environment.

**Legislation mandating that most government payments be made electronically by 1999** -- The Debt Collection Improvement Act of 1996 requires that all federal payments, except tax refunds, be delivered electronically by 1999. Today, nearly 56 percent of nearly 1 billion payments made by Treasury each year are electronic. The Federal Reserve Banks, as fiscal agents of the U.S., are
working closely with Treasury and other agencies to convert the remaining paper-based payments to electronic form. Electronic payments are generally safer, faster, easier, and less expensive than those made by paper check.

**Performance Measures:**

1) Long-term recovery of the costs of providing priced services to depository institutions as required by the Monetary Control Act (including recovery of imputed costs and targeted return on equity) through the fees charged for priced services.

2) Degree to which the Federal Reserve attains continued cost efficiencies in the electronic payments services it provides, as reflected in lower fees for those services.

3) Degree to which the Federal Reserve meets the demand for currency of an acceptable level of quality.

4) Degree to which the Federal Reserve provides efficient and effective fiscal agency and depository services.

5) Modification of Federal Reserve payment systems applications and interfacing systems, as required, for year 2000 compliance and availability of those systems for testing with depository institutions and government agencies by mid-year 1998; modification of other systems by the end of 1998.
DISSEMINATING GOALS AND OBJECTIVES AND HOLDING MANAGERS ACCOUNTABLE FOR RESULTS

The Federal Reserve System is highly decentralized and has a complex governance structure. The seven-member Board of Governors oversees the activities of the System but a significant amount of responsibility is delegated to the twelve regional Reserve Banks. The Reserve Banks carry out the bulk of operations and have substantial autonomy. The Federal Open Market Committee (FOMC), which is comprised of the seven governors and five Reserve Bank presidents, makes major monetary policy decisions at eight meetings annually.

The regional structure of the Federal Reserve is one of its great strengths. Reserve Banks work closely with financial institutions in their regions and are closely tied into their regional economies. The development of Federal Reserve policies is greatly enriched by in-depth knowledge that the regional Banks have of the industrial, agricultural, and financial forces shaping different parts of the economy.

Five standing committees, each comprising up to three governors, administer the activities of the Federal Reserve Board. These committees include: a Committee on Consumer and Community Affairs, a Committee on Economic Affairs, a Committee on Federal Reserve Bank Affairs, a Committee on Supervisory and Regulatory Affairs, and a Budget Committee.

In general, the Board committees communicate strategic goals to Board division directors who, in turn, communicate them to managers and staff. Managers and staff are held accountable for meeting objectives through the Board's performance management program which ties compensation to achievement of specific objectives.
PROGRAM EVALUATIONS

The activities of the System are critical to the economic well being of the country. The System affects the lives of American citizens through its monetary policy actions, supervision and regulation activities, and payment systems operations. These effects are significant, on-going, and highly visible. It is essential that the analyses performed by staff to influence policy decisions be reviewed at later dates to determine whether the desired effect was achieved and if the benefits of the activity outweigh its costs.

Monetary Policy

The Federal Reserve's conduct of monetary policy is evaluated frequently through a number of vehicles. First, the Federal Reserve Act requires the Board of Governors to report to the Congress semiannually on the conduct of monetary policy. The Chairman of the Board of Governors presents testimony to Senate and House committees on these reports. By statute, these committees subsequently report to their full Houses on the conduct of monetary policy. More generally, Federal Reserve policy makers testify frequently before congressional committees on monetary policy and other Federal Reserve responsibilities, and from time to time congressional hearings include evaluations of monetary policy by academic and other experts from outside the Federal Reserve. As a matter of critical national importance, national and business newspapers and magazines report on and analyze monetary policy decisions and their effects virtually continuously.

Banking Supervision and Regulation

As part of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), the Inspector General of the Federal Reserve is required to review any failure of a state member bank that results in a material loss to the Bank Insurance Fund (BIF). The purpose of this review is to identify the cause of the failure, determine whether supervision was in accordance with policy standards, and if so, whether policies and standards are in need of revision. There have been no material loss reviews required in the past two years.

Payments System Services

The Board recently established a committee to review the Federal Reserve's role in providing payments system services. Among other things, the committee is analyzing the economic factors influencing the supply of and demand for retail services (primarily small dollar payments), studying trends in the financial services industry including the development of new and emerging payment services, and reviewing the Federal Reserve's role in those services. Ten national and fifty-two regional forums were held to draw on the insights and expertise of the banking industry and other payments system participants. Attendees represented a diverse group of payments system participants, including representatives from large and small banks, private
payments system providers, corporations, trade associations, academicians, consultants, and emerging payments system service providers (over 500 representatives from 473 organizations participated). Upon completion of their work, which is expected shortly, the committee will issue specific recommendations for Federal Reserve involvement in retail payment services.
MANAGEMENT ISSUES

The Federal Reserve is actively working to address the management issues discussed below, many of which have been identified by the General Accounting Office (GAO).

Role of Federal Reserve in Providing Payment Systems

A committee has been established to examine the role of Federal Reserve System in providing financial services to banks and government agencies. Among other things, the committee will analyze the costs and benefits to the Federal Reserve and the taxpayers of various options of delivering those services. Upon completion of the committee's work, its findings will be provided to both Congress and the public.

Century Date Compliance of Information Systems

The century date compliance of its information systems and those of financial institutions it regulates is one of the highest priorities of the Federal Reserve. The Federal Reserve has developed and is executing a comprehensive plan to ensure its own year 2000 readiness. The scope of the CDC project is to ensure the effective transition of all hardware and software systems to perform accurately in the year 2000. The Year 2000 project requires analyzing and modifying all mainframe processing, distributed processing, and environmental systems. Also, all the date references in data flows the Board receives from Reserve Banks, federal and international agencies, and the private sector must be thoroughly checked.

Reserve Banks Oversight

The Federal Reserve is taking steps to strengthen further its internal control and oversight mechanisms. For example, the Federal Reserve has adopted a policy whereby independent external audits of individual financial statements of the twelve Reserve Banks, the combined financial statements for the Banks, and the System Open Market Account will be conducted annually. Previously, the Board's internal examination program conducted an annual balance sheet examination of each Bank.

Strategic Planning and Budget Process

The Board's planning and budget process is being modified to make it more useful both to the Board and the staff in addressing priorities, making decisions about resources, and improving effectiveness of operations. These changes include adopting use of a biennial budget, establishing a Board Budget Committee, and establishing a Strategic Planning Group to advise the Budget Committee. The new process will put more emphasis on planning and involve the Board itself more actively and earlier in the process in discussing alternative future uses of resources and trade-offs among them. It will focus on the use of on-going resources rather than incremental initiatives.
INTERAGENCY COOPERATION AND CROSS CUTTING ISSUES

While many aspects of the Federal Reserve's mission are unique to the organization, the Federal Reserve does not operate in a vacuum. To coordinate its activities, staff works closely with a broad variety organizations and individuals on a daily basis. Regular meetings with senior officials from the Department of the Treasury, regulatory agencies such as the Securities and Exchange Commission, and other executive branch agencies help ensure consistency of purpose and coordination of actions. One area of the Federal Reserve's mission, supervision and regulation of financial institutions, is shared with other regulatory agencies. We work closely with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the National Credit Union Administration, and state banking regulatory agencies to ensure the safety and soundness of the nation's financial institutions and to enforce consumer safeguards. The primary mechanism to ensure coordinated and non-duplicative activity is the Federal Financial Institutions Examination Council (FFIEC), established by Congress in 1979. The Board and other federal and state financial regulatory agencies are represented on the Council. Major regulatory policy actions, data collection, and other activities are coordinated through that body to ensure efficiency and minimize regulatory burden consistent with safety and soundness and fair treatment of consumers.

STAKEHOLDER CONSULTATIONS

The goals and objectives of the Federal Reserve System have been developed keeping in mind feedback regularly received from the public, Congress, industry groups, federal and state regulators, academics, and others. The Federal Reserve relies heavily on advisory and working committees to provide input on a wide variety of issues. These committees include: the Federal Advisory Council which provides input on economic and banking matters; the Consumer Advisory Council which provides input on consumer protection matters; the Thrift Institutions Advisory Council which provides input on the needs and problems of thrift institutions; and Federal Reserve Bank advisory committees which provide advice to Reserve Banks on agriculture and small business matters. The Federal Reserve also consults regularly with a broad variety of banking and financial service industry groups. Strategic initiatives are developed and carried out in close coordination with other federal and state banking regulatory agencies through participation in the Federal Financial Institutions Examinations Council and with state banking regulators through regular consultations.