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## *Introduction*

The Federal Reserve System consists of the Board of Governors in Washington, D.C., the twelve Federal Reserve Banks with their twenty-five Branches distributed throughout the nation, the Federal Open Market Committee (FOMC), and three advisory groups—the Federal Advisory Council, the Consumer Advisory Council, and the Thrift Institutions Advisory Council. The System was created in 1913 by the Congress to establish a safe and flexible monetary and banking system. Over the years, the Congress has given the Federal Reserve more authority and responsibility for achieving broad national economic and financial objectives.

As the nation's central bank, the Federal Reserve has many, varied responsibilities. It acts to ensure that the nation's economy grows at a pace consistent with price stability; it serves as the nation's lender of last resort, with responsibility for forestalling national liquidity crises; and it is involved in bank supervision and regulation, with responsibilities for bank holding companies, financial holding companies (created under the Gramm-Leach-Bliley Act, enacted in November 1999), state-chartered banks that are members of the Federal Reserve System, the foreign activities of U.S. banks, and the U.S. activities of foreign banks. The Federal Reserve also administers the nation's financial consumer protection laws.

The Federal Reserve System plays a major role in the nation's payment mechanism. The Reserve Banks distribute currency and coin; process Fedwire, automated clearinghouse, and securities transfers; and process checks. In addition, the Federal Reserve Banks serve as the fiscal agents of the United States and pro-

vide a variety of financial services for the Treasury and other government agencies. For a fuller discussion of the Federal Reserve's responsibilities, see the Board publication *The Federal Reserve System: Purposes and Functions*.

### **Summary of 2002 Income and Expenditures**

In carrying out its responsibilities in 2002, the Federal Reserve System incurred an estimated \$1.6 billion in net operating expenses. Total spending of an estimated \$2.9 billion was offset by an estimated \$1.3 billion in revenue from priced services, claims for reimbursement, and other income.

The major source of Federal Reserve income is earnings from the portfolio of U.S. government securities in the System Open Market Account, estimated at \$25.5 billion in 2002. Earnings in excess of expenses, dividends, and surplus are transferred to the U.S. Treasury—an estimated \$24.5 billion in 2002. (These earnings are treated as receipts in the U.S. budget accounting system and as anticipated earnings projected by the Office of Management and Budget in the U.S. budget.)

### **Budget Processes**

Beginning with the 1998–99 budget, the Board of Governors has operated on a two-year budget cycle and a four-year planning cycle. This multiyear process allows the Board to define and implement long-term strategies across functional areas. Given their current business needs, the Federal Reserve Banks maintain an

annual budget cycle. For more information on the budget processes, see appendix A.

## Operational Areas

In 2002, the Federal Reserve System accounted for costs using the following categories—monetary and economic policy, supervision and regulation of financial institutions, services to financial institutions and the public, services to the U.S. Treasury and other government agencies, and System policy direction and oversight.

### Monetary and Economic Policy

The monetary and economic policy operational area encompasses Federal Reserve actions to influence the availability and cost of money and credit in the nation's economy. In 2002, the FOMC held eight regularly scheduled meetings and adjusted the federal funds rate once.

A vast amount of banking and financial data flows through the Reserve Banks to the Board, where it is compiled and made available to the public. The research staffs at the Board and the Reserve Banks use these data, along with information collected by other public and private institutions, to assess the state of the economy and the relationships between the financial markets and economic activity. Staff members provide background information for the Board of Governors and for each meeting of the FOMC by preparing detailed economic and financial analyses and projections for the domestic economy and international markets. The Board and the FOMC use these analyses and projections in setting reserve requirements, setting the discount rate (which affects the cost of borrowing), and conducting open market operations. Staff members also conduct longer-run

economic studies on regional, national, and international issues.

### Supervision and Regulation

The Federal Reserve System plays a major role in the supervision and regulation of banks and bank holding companies. The Board of Governors adopts regulations to carry out statutory directives and establishes System supervisory and regulatory policies; the Reserve Banks conduct on-site examinations and inspections of state member banks and bank holding companies, review applications for mergers, acquisitions, and changes in control from banks and bank holding companies, and take formal supervisory actions. In 2002, the Federal Reserve conducted 550 examinations of state member banks (some of them jointly with state agencies) and 580 inspections and 3,683 risk assessments of bank holding companies; it acted on 1,885 international and domestic applications.

The Board also enforces state member banks' and certain foreign banking organizations' compliance with the federal laws protecting consumers in their use of credit and deposit products. In 2002, the System conducted 358 compliance examinations, including 301 covering state member banks and 57 covering foreign banking organizations. Procedures related to the Community Reinvestment Act were included in 265 of the compliance examinations.

The Board's supervisory responsibilities also extend to the foreign operations of U.S. banks and, under the International Banking Act, to the U.S. operations of foreign banks. Beyond these activities, the Federal Reserve maintains continuous oversight of the banking industry to ensure the overall safety and soundness of the financial system. This broader responsibility is reflected in the System's presence in financial markets, through open market operations, and in the Fed-

eral Reserve's role as lender of last resort.

### Services to Financial Institutions and the Public

The Federal Reserve System plays a central role in the nation's payment mechanism, which is composed of many independent systems that move funds among financial institutions across the country. The Reserve Banks obtain currency and coin from the Bureau of Engraving and Printing and from the Mint and distribute them to the public through depository institutions; they receive deposits of currency and coin from depository institutions; and they identify counterfeits and destroy currency that is unfit for circulation. In 2002, the Reserve Banks received \$574.7 billion in currency and \$4.6 billion in coin from depository institutions, distributed an estimated \$617.4 billion in currency and \$5.9 billion in coin, and destroyed \$92.5 billion in unfit currency.

The Reserve Banks (along with their Branches and regional centers) also process checks for collection. In 2002, the Reserve Banks processed approximately 16.6 billion commercial checks for collection, with a total value of about \$15 trillion.

The Federal Reserve also plays a central role in the nation's payments mechanism through its Fedwire Funds Service. Through this service, depository institutions can draw on their reserve or clearing balances at the Reserve Banks and transfer funds to other institutions that maintain accounts at the Reserve Banks. In 2002, Fedwire funds participants originated approximately 115 million Fedwire funds transfers, valued at about \$406 trillion.

The Federal Reserve allows participants in private clearing arrangements to exchange and settle transactions through reserve or clearing account balances. The

Reserve Banks' National Settlement Service provides settlement services to approximately 70 local and national private arrangements, primarily check clearinghouse associations but also other types of arrangements. In 2002, the Reserve Banks processed over 415,000 settlement entries for these arrangements.

The Federal Reserve's ACH service allows depository institutions to send or receive payments electronically instead of by check. Institutions use the ACH service for credit and debit transactions. In 2002, the Reserve Banks processed approximately 5.9 billion ACH transactions, valued at about \$15.8 trillion. Approximately 15 percent of the transactions were for the federal government; the rest were for commercial establishments.

Reserve Banks provide securities services for the handling of book-entry (computer-based) securities and the collection of physical interest coupons and miscellaneous items. The Fedwire Securities Service allows participants to electronically transfer to other participants securities issued by the Treasury, federal government agencies, and other approved entities. In 2002, Fedwire securities participants originated approximately 17 million transfers, valued at about \$229 trillion. The noncash collection service, through which maturing or called municipal coupons and bonds are presented for collection, processed about 305,000 transactions in 2002.

### Services to the U.S. Treasury and Other Government Agencies

The Reserve Banks provide fiscal agency and depository services to the U. S. government. Through deposit accounts at Reserve Banks, the government issues checks, makes payments, and collects receipts. The Reserve Banks also process Fedwire funds transfers and automated clearinghouse payments and provide the Treasury with daily statements of account

activity. Reserve Banks provide claims for reimbursement of approximately \$300 million to the Treasury and other government agencies for the full cost of providing these services; reimbursement was received or is expected for all of the expenses incurred.

As fiscal agents, Reserve Banks provide the Department of the Treasury with services related to the federal debt. For example, Reserve Banks issue, service, and redeem marketable Treasury securities and savings bonds; they also process secondary-market Fedwire securities transfers initiated by depository institutions. In 2002, the Reserve Banks processed over 166,000 competitive and noncompetitive bids for Treasury securities and printed and mailed 37.2 million savings bonds. The Reserve Banks operate two book-entry (computer-based) securities systems for the custody of Treasury securities—the Fedwire book-entry securities system and TreasuryDirect. Almost all book-entry Treasury securities are maintained on Fedwire, which is also the nation’s principal securities transfer mechanism; the remainder are maintained on TreasuryDirect, which is used by individuals.

As fiscal agents of the United States, the Reserve Banks also invest excess Treasury balances with approximately 1,200 depository institutions, which pay interest to Treasury for the use of the funds. In 2002, the Reserve Banks invested \$504 billion of Treasury balances through the program. While most funds are callable on demand, the Reserve Banks recently piloted a program to auction investments with depository institutions for a set term.

As depositories, Reserve Banks collect and disburse funds on behalf of the federal government. The Reserve Banks

maintain the Treasury’s funds account, accept deposits of federal taxes and fees, pay checks drawn on the Treasury’s account, and make Fedwire and automated clearinghouse payments on behalf of the Treasury. In 2002, the Reserve Banks processed over 883 million ACH transactions and 289 million paper checks for the Treasury. In 2002, the Reserve Banks also assisted Treasury in its efforts to increase the use of electronic payment vehicles by assuming additional responsibilities for the Pay.gov Internet portal, which permits the public to pay Treasury and agencies via the Internet.

The Reserve Banks also provide fiscal agency and depository services to other domestic and international government agencies. Depending on the authority under which the services are provided, the Reserve Banks may maintain book-entry accounts of government agency securities; provide custody for the stock of unissued, definitive (physical) securities; maintain and update balances of outstanding book-entry and definitive securities for issuers; maintain funds accounts for government agencies; and provide various payment services, including the processing and destroying of redeemed food coupons for the U.S. Department of Agriculture.

### System Policy Direction and Oversight

This operational area encompasses the Board’s activities in supervising Board and Reserve Bank programs. At the System level, the expenses for these activities are considered overhead and are therefore allocated across the other operational areas. At the Board level, these expenses are not treated as overhead or allocated to other operational areas. ■

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As the nation's central bank, the Federal Reserve has many, varied responsibilities: It acts to ensure that the nation's economy grows at a pace consistent with price stability; it serves as the nation's lender of last resort, with responsibility for forestalling national liquidity crises; and it is involved in bank supervision and regulation, with responsibilities for bank holding companies, financial holding companies (created under the Gramm-Leach-Bliley Act, enacted in November 1999), state-chartered banks that are members of the Federal Reserve System, the foreign activities of U.S. banks, and the U.S. activities of foreign banks. The Federal Reserve also administers the nation's financial consumer protection laws.

The Federal Reserve System plays a major role in the nation's payment mechanism. The Reserve Banks distribute currency and coin; process Fedwire, automated clearinghouse, and securities transfers; and process checks. In addition, the Federal Reserve Banks serve as the fiscal agents of the United States and pro-

vide a variety of financial services for the Treasury, other government agencies, and other fiscal principals. For a fuller discussion of the Federal Reserve's responsibilities, see the Board publication *The Federal Reserve System: Purposes and Functions*.

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The major source of Federal Reserve income is earnings from the portfolio of U.S. government securities in the System Open Market Account, estimated at \$22.6 billion in 2003. Earnings in excess of expenses, dividends, and surplus are transferred to the U.S. Treasury—in 2003 an estimated \$22.0 billion. (These earnings are treated as receipts in the U.S. budget accounting system and as anticipated earnings projected by the Office of Management and Budget in the U.S. budget.)

### **Budget Processes**

Beginning with the 1998–99 budget, the Board of Governors has operated on a two-year budget cycle and a four-year planning cycle. This multiyear process allows the Board to define and implement long-term strategies across functional areas. Given their current business needs,

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### Monetary and Economic Policy

The monetary and economic policy operational area encompasses Federal Reserve actions to influence the availability and cost of money and credit in the nation's economy. In 2003, the FOMC held eight regularly scheduled meetings and adjusted the federal funds rate once.

A vast amount of banking and financial data flows through the Reserve Banks to the Board, where it is compiled and made available to the public. The research staffs at the Board and the Reserve Banks use these data, along with information collected by other public and private institutions, to assess the state of the economy and the relationships between the financial markets and economic activity. Staff members provide background information for the Board of Governors and for each meeting of the FOMC by preparing detailed economic and financial analyses and projections for the domestic economy and international markets. The Board and the FOMC use these analyses and projections in setting reserve requirements, setting the discount rate (which affects the cost of borrowing), and conducting open market operations. Staff members also conduct longer-run

economic studies on regional, national, and international issues.

### Supervision and Regulation

The Federal Reserve System plays a major role in the supervision and regulation of banks and bank holding companies. The Board of Governors adopts regulations to carry out statutory directives and establishes System supervisory and regulatory policies; the Reserve Banks conduct on-site examinations and inspections of state member banks and bank holding companies, review applications for mergers, acquisitions, and changes in control from banks and bank holding companies, and take formal supervisory actions. In 2003, the Federal Reserve conducted 581 examinations of state member banks (some of them jointly with state agencies) and 446 inspections and 3,141 risk assessments of bank holding companies; it acted on 2,668 international and domestic applications.

The Board also enforces state member banks' and certain foreign banking organizations' compliance with the federal laws protecting consumers in their use of credit and deposit products. Between July 1, 2002, and June 30, 2003, the System conducted 402 consumer compliance examinations, including 368 covering state member banks and 34 covering foreign banking organizations. Additionally, the System performed 313 Community Reinvestment Act examinations.

The Board's supervisory responsibilities also extend to the foreign operations of U.S. banks and, under the International Banking Act, to the U.S. operations of foreign banks. Beyond these activities, the Federal Reserve maintains continuous oversight of the banking industry to ensure the overall safety and soundness of the financial system. This broader responsibility is reflected in the System's presence in financial markets, through

open market operations, and in the Federal Reserve's role as lender of last resort.

### Services to Financial Institutions and the Public

The Federal Reserve System plays a central role in the nation's payment systems by ensuring that enough currency and coin are in circulation to meet the public's demand. The Bureau of Engraving and Printing prints currency and the U.S. Mint mints coin that the Reserve Banks distribute to the public through depository institutions. Reserve Banks also receive deposits of currency and coin from depository institutions, identify suspect currency that they forward to the U.S. Secret Service, and destroy currency that is unfit for circulation. In 2003, the Reserve Banks received approximately \$596.9 billion in currency and \$4.9 billion in coin from depository institutions, distributed approximately \$633.4 billion in currency and \$6.0 billion in coin, and destroyed \$101.3 billion in unfit currency.

The Reserve Banks (along with their Branches and regional processing centers) also process checks for collection. In 2003, the Reserve Banks processed approximately 15.8 billion commercial checks for collection, with a total value of about \$15.4 trillion.

The Federal Reserve also plays a central role in the nation's payment systems through its Fedwire Funds Service. Through this service, depository institutions can draw on their reserve or clearing balances at the Reserve Banks and transfer funds to other institutions that maintain accounts at the Reserve Banks. In 2003, Fedwire funds participants originated approximately 126 million Fedwire funds transfers, valued at about \$437 trillion.

The Federal Reserve allows participants in private clearing arrangements to settle transactions through reserve or

clearing account balances. The Reserve Banks' National Settlement Service provides settlement services to approximately 70 local and national private arrangements, including check clearing-house associations, the automated clearinghouse network, and credit card processors. In 2003, the Reserve Banks processed over 442,700 settlement entries for these arrangements.

The Federal Reserve's ACH service allows depository institutions to send or receive payments electronically instead of by check. Institutions use the ACH service for credit and debit transactions. In 2003, the Reserve Banks processed approximately 6.5 billion ACH transactions, valued at about \$16.8 trillion. Approximately 16.4 percent of the transactions were for the federal government; the rest were for commercial establishments.

Reserve Banks provide securities services for the handling of book-entry (computer-based) securities and the collection of physical interest coupons and miscellaneous items. The Fedwire Securities Service allows participants to electronically transfer to other participants securities issued by the Treasury, federal government agencies, and other approved entities. In 2003, Fedwire securities participants originated approximately 10 million transfers valued at about \$268 trillion. The noncash collection service, through which maturing or called municipal coupons and bonds are presented for collection, processed about 280,100 transactions in 2003.

### Services to the U.S. Treasury and Other Government Agencies

The Reserve Banks provide fiscal agency and depository services to the U.S. government. Through deposit accounts at Reserve Banks, the government issues checks, makes payments, and collects receipts. The Reserve Banks also process

Fedwire funds transfers and automated clearinghouse payments and provide the Treasury with daily statements of account activity. Reserve Banks provide claims for reimbursement of approximately \$320 million to the Treasury and other government agencies for the full cost of providing these services; reimbursement was received or is expected for all of the expenses incurred.

As fiscal agents, Reserve Banks provide the Department of the Treasury with services related to the federal debt. For example, Reserve Banks issue, service, and redeem marketable Treasury securities and savings bonds; they also process secondary-market Fedwire securities transfers initiated by depository institutions. In 2003, the Reserve Banks processed nearly 140,000 competitive and noncompetitive bids for Treasury securities and printed and mailed more than 40 million savings bonds. The Reserve Banks operate two book-entry (computer-based) securities systems for the custody of Treasury securities—the Fedwire book-entry securities system and TreasuryDirect. Almost all book-entry Treasury securities are maintained on Fedwire, which is also the nation's principal securities transfer mechanism; the remainder are maintained on TreasuryDirect, which is primarily used by individuals.

As fiscal agents of the United States, the Reserve Banks also invest excess Treasury balances with more than 1,100 depository institutions, which pay interest to Treasury for the use of the funds. In 2003, the Reserve Banks invested \$438 billion of Treasury balances through the program. While most funds are callable on demand, the Reserve Banks implemented a program to place investments with depository institutions for a set term.

As depositories, Reserve Banks col-

lect and disburse funds on behalf of the federal government. The Reserve Banks maintain the Treasury's funds account, accept deposits of federal taxes and fees, pay checks drawn on the Treasury's account, and make Fedwire and automated clearinghouse payments on behalf of the Treasury. In 2003, the Reserve Banks also assisted Treasury in its efforts to increase the use of electronic payment vehicles by assuming additional responsibilities for the Pay.gov Internet portal, which permits the public to pay Treasury and agencies via the Internet.

The Reserve Banks also provide fiscal agency and depository services to other domestic and international government agencies. Depending on the authority under which the services are provided, the Reserve Banks may maintain book-entry accounts of government agency securities, provide custody for the stock of unissued, definitive (physical) securities, maintain and update balances of outstanding book-entry and definitive securities for issuers, maintain funds accounts for government agencies, and provide various payment services, including the processing and destroying of redeemed food coupons for the U.S. Department of Agriculture.

### System Policy Direction and Oversight

This operational area encompasses activities by the Board of Governors in supervising Board and Reserve Bank programs. At the System level, the expenses for these activities are considered overhead and are therefore allocated across the other operational areas. At the Board level, these expenses are not treated as overhead nor allocated to other operational areas. ■