

STRUCTURE, GOVERNANCE, REPRESENTATION:
Federal Reserve Member Banks and Federal Reserve Bank Stock

Esther L. George
President and Chief Executive Officer
Federal Reserve Bank of Kansas City

July 2016

The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

INTRODUCTION

The Fixing America's Surface Transportation (FAST) Act changed the Federal Reserve Bank stock dividend rate for member banks with assets of more than \$10 billion. The Act also placed a cap of \$10 billion on the aggregate surplus funds of the Federal Reserve and directed that any excess be transferred to the Treasury general fund. The potential policy implications of modifying dividends to member banks, or more generally, the requirement for member banks to purchase stock in a regional Federal Reserve Bank, should be studied carefully before altering this long-standing institutional design of public and private interests serving the American public.

In designing the governance structure more than a century ago, Congress accepted a compromise proposal from President Woodrow Wilson to create a central bank with a combined public and private structure with those roles filled respectively by the Board of Governors of the Federal Reserve System and the regional Reserve Banks. In this design, the stock ownership of the regional Reserve banks is a key component in a central bank design that provides representation for both the public and private interests with each acting as a potential limit on the control of the other.

The debate regarding the role of Federal Reserve stock in the Federal Reserve System structure is not a new one: In 1938, Congressman Wright Patman proposed that the government should take over the Reserve Bank stock, effectively turning the regional Reserve Banks into full government entities. At the heart of this issue is whether changes that aim to alter the private/public status of the central bank and potentially nationalize the 12 regional Federal Reserve Banks could undermine the barriers carefully constructed by Congress to protect against political pressures on Federal Reserve policies.

This analysis offers historical perspective on these issues, as well as an assessment of the effectiveness of the current governance and structure of the Federal Reserve System.

A LOOK BACK ON CENTRAL BANKING IN THE UNITED STATES

A careful reading of Federal Reserve history will find that proposals for increased government authority over the Federal Reserve are often raised most pointedly during periods when government debt is high. Pressure on the Federal Reserve to implement policy supportive of government spending dates back almost to the 1913 founding of the Federal Reserve and the

subservient role the Federal Reserve soon assumed related to government financing demands in connection with World War I. Similar pressure continued during and after World War II. Eventually, the Federal Reserve's resistance to continually supporting government spending led to a formal accord with the Treasury in 1951.

The list of events that have occurred in these environments is long and includes such high-profile instances as pressure from President Lyndon Johnson to hold rates low as a means of supporting his proposals during the Vietnam War to calls for Federal Reserve Chairman Paul Volcker's resignation during the Federal Reserve System's successful, but painful, battle against high inflation. Beyond these major events, numerous legislative initiatives have met varying degrees of success over the years but have overall led to what Duke University economics professor Thomas Havrilesky termed the "deterioration of traditional constraints on the political manipulation of monetary policy" since the modern Federal Open Market Committee (FOMC) was created in 1935.¹

The Failure of Earlier Central Bank Designs

At the time of the Federal Reserve's founding, the United States had already witnessed two unsuccessful attempts at establishing a central bank. Neither was able to outlast their initial 20-year charter.

There was intense political debate around the creation of both the First Bank of the United States, in 1791, and its successor, the Second Bank of the United States, in 1816. While recognizing the need for the stability that a central bank could provide, many Americans with vivid memories of the fight to win independence from England were understandably leery of creating another powerful institution. As a result, both the First and Second Banks were the focus of significant public distrust. Both were highly centralized institutions that many Americans viewed as too closely aligned with powerful political and financial interests of the Northeast. In the early 1900s, after a series of financial crises, a third effort was launched to create a central bank with a structure that combined both government and private interests.

Carter Glass, the House sponsor of the Federal Reserve Act and the legislation's key author, explained the challenges in a report to the 63rd Congress:

¹ T. Havrilesky, "[The Politicization of Monetary Policy: The Vice Chairman as the Administration's Point Man.](#)" *Cato Journal*, Vol. 13, No. 1 (Spring/Summer 1993). Copyright Cato Institute.

“In the United States, with its immense area, numerous natural divisions, still more competing divisions, and abundant outlets to foreign countries, there is no argument either of banking theory or expediency which dictates the creation of a single central banking institution, no matter how skillfully managed, how carefully controlled or how patriotically conducted.”

As Glass’s comment suggests, the concern about centralization was not something that could be addressed solely by geography or the number of bank facilities. Nor was it simply a question about adjusting the bank’s ownership structure. While both of those are elements of a decentralized structure, arguably the most important issue—and the glaring weakness of both the First and Second Bank—was the centralization, or the perceived centralization, of control.

Indeed, both the First and Second Banks were geographically diverse with branch offices located in the important financial centers of their eras. Additionally, both had a combined public/private ownership; however, the ownership structure utilized in each case was problematic for two key reasons: the need for profits, and the homogeneity of ownership and centralization of control.

- The Risks of a Structure that Requires Profits

Although the nation’s first two central banks had slight differences, particularly in their size, they were alike in many key structural ways. In both cases, private investors held an 80 percent ownership stake while the government held the remaining 20 percent. Investors acquired their shares through an initial public offering (IPO) process that was similar to other public stock offerings. In the case of both banks, the IPO involved the immediate sale of subscriptions, or “scrips,” that were essentially a down payment for a later stock purchase. Scrip and stock purchases for the First Bank, which required the combined use of specie (gold or silver) and U.S. debt securities to complete the transaction, created what is now considered the nation’s first financial crisis when scrip prices soared on high demand, causing debt markets to become distorted. While this distortion and the resulting U.S. financial crisis was an early indication of one of the many potential risks in a profit-seeking central bank structure, the era’s more prominent international example involved the privately-held French central bank, Banque de France, which took actions in the 1880s to

protect and increase profits—moves that had a negative impact on its effectiveness as a central bank.

- The Consequences of a Homogeneous Leadership Structure

Shares for both the First and Second Banks were prohibitively expensive for most Americans. Stock in the First Bank, for example, was initially offered at \$400 per share (the equivalent of about \$10,000 in 2016 after accounting for inflation). Stock in the Second Bank was still pricey at about a quarter of that cost. As a result, U.S. central bank ownership was vested primarily in the hands of wealthy and powerful individuals (including—perhaps unexpectedly—a number of foreign investors). Similarly, the majority of the directors of the First and Second Banks were elected from the ranks of the politically and financially powerful, including some members of Congress, who lived in and did business in the nation’s power centers. The lack of diversity of central bank leadership was a major criticism, especially from those living outside of the East Coast.

The Combination of Public and Private Components: Checks and Balances

Economic historians sometimes note that the fundamental issue about a U.S. central bank correlates with the fundamental issue dividing America’s two chief political ideologies: the role of government versus the role of the private sector.

At the time of the Federal Reserve’s founding, most of the world’s other central banks were privately held institutions. In the United States, the Federal Reserve’s congressional creators recognized that a private structure would not work and instead devised a structure with checks and balances between the private sector and the government.²

Balancing government authority over the central bank was not solely about placating political ideologies that preferred limited government. The primary motivation was to avoid the use of monetary policy and inflation as the means of financing government debt. Related to this concern, of course, was the risk of Federal Reserve policy manipulation for political gain.

² T. Todd, [The Balance of Power: The Political Fight for an Independent Central Bank, 1790-Present](#), Federal Reserve Bank of Kansas City, 2009.

To address concerns about national debt funding, the Federal Reserve Act expressly prohibited the direct financing of the Treasury. However, since the Federal Reserve's founding, political pressure to ease monetary policy has surfaced.³

To mitigate this political pressure, the Federal Reserve's creators made the Reserve Banks private entities under the supervision and control of a board of directors with authority to perform all duties usually pertaining to directors of a banking association. This includes the appointment of the president and first vice president (directors affiliated with supervised entities are no longer involved in this process), appointment of officers, prescribing by-laws, and designating a representative for the FOMC. As initially designed, the Reserve Banks were far more autonomous than they are today. While the Federal Reserve System's government component has always been responsible for Reserve Bank oversight, the Federal Reserve's key functions, including monetary policy, were under the purview of the Reserve Banks during the System's early history. Over time, the monetary policy function has become balanced between the private and public components with the Board of Governors holding the majority votes. The FOMC consists of 12 members: seven members of the Board of Governors and five Reserve Bank presidents.

Private Sector Involvement

While private sector involvement through a network of separate and distinct Reserve Banks located across the country expanded leadership diversity and helped balance government authority, on the surface it presented another problem: how to engage the private sector while preventing risks associated with a pure-profit motivation. This aspect was addressed by putting restrictions on Reserve Bank stock and establishing the Board of Governors' authority for oversight of the Reserve Banks.

While law requires stock ownership in Federal Reserve Banks as a condition of a commercial bank's membership in the Federal Reserve System, this stock is not like stock available on public markets. It may not be sold, traded or pledged as security for a loan. It does pay a dividend rate that is established by statute and, as a result, cannot be manipulated through the use of Federal Reserve policy tools or otherwise. This design provides the Federal Reserve

³ T. Todd, [Under Pressure: Politics and The Federal Reserve During the 1990-1991 Recession](#), Federal Reserve Bank of Kansas City, 2011.

System with private ownership over the Reserve Banks, but without the profit motivation that can distort policy.

Stock ownership allows member banks to nominate and elect Class A and B directors to a Reserve Bank's Board of Directors. However, unlike traditional corporations which grant one vote per share, the Federal Reserve Act provides for class voting wherein each member bank receives one vote as a member of one of three designated classes based on the total amount of capital, surplus and retained earnings of the member bank. There are further limitations on voting as each class elects only one Class A and one Class B director.

In addition to these restrictions on Reserve Bank stock, the Board of Governors plays an important oversight role, including its authority to:

- Examine at its discretion the accounts, books and affairs of each Reserve Bank;
- Suspend or remove any officer or director of a Reserve Bank;
- Order an annual independent audit of the financial statements of each Reserve Bank;
- Approve compensation provided by Reserve Banks to directors, officers, and employees;
- Approve the president and first vice president appointed by the Reserve Bank Class B and C directors; and
- Appoint three of the nine Reserve Bank directors, including the Reserve Bank's chair and deputy chair.

MEMBER BANKS HELP RESERVE BANKS FULFILL THEIR MISSION

Stockholders of the Federal Reserve System, also referred to as members, have some rights and obligations similar to traditional corporate stockholders in that they provide capital to the Federal Reserve Banks, which are federally-chartered corporations. All national banks along with state-chartered banks that choose the Federal Reserve as the bank's primary federal regulator are required to purchase Federal Reserve stock. By purchasing stock, members are entitled to a dividend fixed by statute as well as a role in Reserve Bank governance.⁴ Members

⁴ The dividend rate was set to 6 percent in the original 1913 Federal Reserve Act to provide a rate of return comparable to alternative risky investments and to attract state-chartered banks as members. Investing in the Federal Reserve in 1913 was not risk-free given that the previous two central banks in the United States had not survived and the short-term ability to pay a steady dividend was unclear. Today, however, Federal Reserve stock is essentially a risk-free perpetual bond as long as a bank chooses

are therefore invested in the Reserve Banks' and Federal Reserve System's success and are integral to the Federal Reserve's mission. Member banks must buy stock in the Federal Reserve Bank equal to 6 percent of the bank's capital, 3 percent of which is held at the regional Reserve Banks. The other 3 percent is callable by the Bank in certain circumstances. Paid-in capital from member banks was the initial funding mechanism for the Federal Reserve Banks, and the 3 percent on call remains available in the event it is needed by the Reserve Banks.

Role of Member Banks in Governance of Reserve Bank Activities

Stockholding member banks elect a portion of the Reserve Banks' director seats,⁵ are core to Reserve Bank corporate governance and provide critical industry information and perspective on economic and banking conditions. At the same time, the structure includes shared oversight with the politically appointed Board of Governors that prevents members from having undue influence on Federal Reserve System activities.

The Federal Reserve Act states that every Reserve Bank "shall be conducted under the supervision and control of a board of directors," and provides that the nine director positions of the Reserve Bank's board of directors are filled through two methods: election and appointment (12 U.S.C. 301). Only three of the nine directors on a Reserve Bank's board may be officers,

to remain a member. While the dividend remained unchanged for over a century, analysis by the Bipartisan Policy Center found it was similar to the average return on the 10-year U.S. Treasury note over that period (A. Klein, K. Readling, O. Weiss, A. Woff; "[Federal Reserve Dividends Should Not Be a Piggy Bank for Congress](#)," Bipartisan Policy Center, 2015). The Fixing America's Surface Transportation Act, 129 Stat. 1312 ("FAST Act"), effective Jan. 1, 2016, changed the dividend for stockholder banks with more than \$10 billion in total consolidated assets from a fixed 6 percent rate to a dividend equal to the lesser of 6 percent or the rate equal to the high yield of the 10-year Treasury note auctioned at the last auction held prior to the payment of the dividend. The 10-year Treasury bond rate is seen by some as a reasonable alternative because it is the benchmark risk-free rate used for most long-term, fixed-rate investments and has a long history of continual issuance. The 30-year Treasury rate might also be an option because it is the longest maturity Treasury rate, but there is a risk that the Treasury could decide to stop issuing it at some point as it did from late 2001 to early 2006.

If a market rate is used as a reference rate, it should not be capped at 6 percent as it currently is for member banks with more than \$10 billion in assets. Using a market rate only when it is below a threshold is economically inconsistent with the notion of tying returns to the market, and it is inequitable to penalize member banks when rates rise above the threshold. In addition, changing the dividend has raised questions about the appearance of breaking an agreement with members. The American Bankers Association asserts that the FAST Act's dividend rate change amounts to an unconstitutional taking of member banks' property without compensation. See Letter dated April 28, 2016 from Rob Nichols, president and CEO of the American Bankers Association, to Robert de V. Frierson, secretary, Board of Governors of the Federal Reserve System (Attachment B). An alternative would be to allow current members to retain the 6 percent dividend or elect the 10-year Treasury rate and issue a new class of stock for new members with the dividend tied to the 10-year Treasury rate.

⁵ Class A and B directors are nominated and elected by member banks within their respective Federal Reserve District. Unlike traditional corporations, which grant one vote per share, the Federal Reserve Act provides for class voting wherein each member, regardless of shares, receives one vote as a member of one of three classes. The classes are designated based on the total amount of capital, surplus and retained earnings of the member bank within the class. Not every class votes each year, and each group within the class elects one Class A and one Class B director.

directors or employees of a bank. Those directors (Class A) are chosen to represent member banks. The remaining six directors (Class B and Class C) cannot be bankers, and are chosen to represent the public with “due but not exclusive regard to agriculture, commerce, industry, services, labor and consumers” (12 U.S.C. 302). While member banks nominate and elect the Class A and Class B directors, this Reserve Bank’s staff plays an important role in considering representation from local and regional organizations to identify qualified candidates. Likewise, Class C directors are identified by Reserve Bank leadership with appointment by the Board of Governors. The chair and vice chair of the Reserve Bank board of directors must be selected from the Board of Governors-appointed Class C directors. Reserve Bank directors come from diverse backgrounds in the region and across industries. They must comply with legal requirements and rules related to their eligibility and conduct.

Benefits of Banker Directors

Reserve Banks are nationally chartered banks that serve as the operating arms of the central bank. They function much like a banker’s bank or a clearing house. As such, banker directors’ knowledge of the payments system complements the Reserve Banks’ operational role in providing financial services to the industry. Indeed, corporate best practices recognize that “the key to effective board composition is ensuring that the people gathered around the board table can leverage their experience to contribute in meaningful ways, to understand the issues, ask the right questions, demand the right information, and make the best possible decisions.”⁶ Class A directors bring informed views related to banking, as well as to the industries of their customers, and act as consolidators of information. For instance, a banker director can provide details about lending trends, stresses in the financial system, and other banking metrics, in addition to sharing insights into farming, commercial real estate, housing and the auto industry. Their reports at Reserve Bank board meetings offer input to economic analysis used by Reserve Bank presidents for monetary policy.

Limitations to Banker Influence

While Reserve Bank directors have important oversight responsibilities for the operation of their respective Reserve Bank, they have no involvement in the Federal Reserve’s supervision

⁶ D. Nadler, B. Behan, and M. Nadler, Building Better Boards (Jossey-Bass 2006).

of depository institutions. By law, the Board of Governors of the Federal Reserve System is responsible for the supervision and regulation of banks, and any information or discussion related to supervisory issues is conducted directly between a regional Reserve Bank's staff and the Board of Governors. In addition, any supervisory matter regarding a Class A director's bank is handled by the Board of Governors.

Reserve Banks may not provide confidential supervisory information to any director (12 C.F.R. 261.2). Moreover, Reserve Bank directors may not participate in bank supervisory matters and may not be consulted regarding bank examination ratings, potential enforcement actions, application/approval matters, or similar supervisory matters. In regard to the Reserve Banks' lending activity involving financial institutions, directors receive only aggregate information about loans extended to ensure adequate knowledge of the Reserve Bank's balance sheet per their oversight responsibilities. Finally, if a banker director wants to convert his or her bank to Federal Reserve membership or take any other actions that would involve Federal Reserve regulatory approval, the Board of Governors in Washington must act on the application without Reserve Bank involvement.

Statutory and Policy Restraints

The directors representing member banks are subject to other restraints by statute and through System policy. As noted above, only Class B and Class C directors appoint, subject to approval by the Board of Governors, the Reserve Bank president and first vice president. Class A directors are excluded from that process to eliminate the perception that they have a role in choosing their regulator. Class A directors also are prohibited from participating in the selection, appointment or compensation of Reserve Bank officers whose primary duties involve supervision of banks for the same reason.

All directors are subject to the [Guide to Conduct for Directors of Federal Reserve Banks and Branches](#), a policy implemented to ensure adherence to high ethical standards of conduct, and avoid actions that might impair the effectiveness of Federal Reserve System operations or in any way discredit the reputation of the System. The policy details procedures when directors are involved in procurements as a means to avoid any actual or apparent conflicts of interest. Further, while the policy allows for waivers, it indicates waivers are both highly unlikely and

strongly discouraged except under the most exigent and extraordinary circumstances. This Reserve Bank has never sought a waiver for a director.

CONCLUSION

Altering the current structure and character of the Federal Reserve System risks diminishing the effectiveness of its operations.

For more than a century, the structural design of the Federal Reserve System has functioned well in carrying out its mandates from Congress. It is possible that Reserve Banks could operate as separate corporate entities without stock ownership, but altering the central banks' current design creates the potential to diminish its effectiveness.

- The private nature of the Reserve Banks through stock issuance to member banks provides balance to the public nature of the Board of Governors. The public's trust and confidence is enhanced by this "balance of power."
- Requiring stock purchases through capital investment creates incentives for member banks to support successful outcomes for the Reserve Banks.
- Rather than a Washington-centric voice for the Federal Reserve System, the structure of 12 separate Reserve Banks encourages strong and varied perspectives from across the country as the System fulfills its mission.
- The structure of the Reserve Banks as separate corporate entities allows private citizens from communities across the country to have input into national economic policy.
- The current decentralized structure insulates the Federal Reserve System from certain political pressures, as the Reserve Bank presidents are not political appointments, but instead chosen by Class B and Class C directors, with approval by the Board of Governors.

Nationalizing the Reserve Banks, and thereby making them essentially field offices of the Board of Governors, would dramatically alter these defining characteristics.