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FEDERAL RESERVE SYSTEM

Current and Future Challenges Require Systemwide Attention

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GAO/T-GGD-96-159

Federal Reserve System: Current and Future Challenges Require Systemwide Attention

Mr. Chairman and Members of the Committee:

We are pleased to appear today to discuss our recently issued report on the Federal Reserve System.[1] The findings and conclusions of this report are based on the most comprehensive review that we have ever undertaken of the Federal Reserve's operations. While we focused our review on the Federal Reserve's major operational activities and expenses, we did not review its monetary policy-making and foreign transactions, because of limitations on our audit authority.[2]

As you know, Mr. Chairman, Congress established the Federal Reserve in 1913 as our nation's independent central bank. The Federal Reserve is unique among federal entities in its mission, structure, and especially in its financing. In addition to its well-known role in conducting monetary policy, the Federal Reserve has several other important functions, such as managing our nation's payment system, providing services to financial institutions and government agencies, and supervising and regulating banks and bank-holding companies. The System's structure comprises a 7-member Board of Governors, which is a federal agency; 12 Federal Reserve Banks, which are federally chartered private corporations; and 25 branches. This structure has remained virtually unchanged since it was established despite the significant shifts in demographics and economic activity that have occurred since then. Unlike federal agencies that are funded by congressional appropriations, the Federal Reserve is a self-financing entity that deducts its expenses from its revenues and transfers the remaining amounts to the U.S. Treasury. Because an additional dollar of Federal Reserve cost is an additional dollar of lost federal revenue, the costs of operating the Federal Reserve System are borne by U.S. taxpayers just like the costs of any federal agency.

Over the 1988 to 1994 period, the Federal Reserve's average annual revenue was $22.0 billion, which greatly exceeded its average annual expenses and other deductions of $2.5 billion. Each year the Federal Reserve returned to the Treasury about $16 billion to $24 billion. The

[1]Federal Reserve System: Current and Future Challenges Require Systemwide Attention (GAO/GGD-96-128, June 17, 1996).

[2]Under the Federal Banking Agency Audit Act, 31 U.S.C. section 714(b), our audits of the Federal Reserve Board and Federal Reserve banks may not include (1) transactions for or with a foreign central bank or government, or nonprivate international financing organization; (2) deliberations, decisions, or actions on monetary policy matters; (3) transactions made under the direction of the Federal Open Market Committee; or (4) a part of a discussion or communication among or between members ofthe Board of Governors and officers and employees of the Federal Reserve System related to items (1), (2), or (3). See Federal Reserve System Audits: Restrictions on GAO's Access (GAO/T-GGD-94-44), statement of Charles A. Bowsher.

largest source of revenue for the Federal Reserve is the interest earned on the U.S. securities it holds as backing or "collateral" for over $380 billion in Federal Reserve notes that circulate as our nation's paper currency. This interest income accounted for almost 90 percent of total Federal Reserve revenue in 1994 and virtually guarantees that the System will earn a substantial "profit" each year. Fees that the Federal Reserve is required to charge financial institutions for providing "priced services," such as check clearing and electronic funds transfers, account for most of the System's other revenues.

The largest deduction that the Federal Reserve makes each year from its revenues is for the operating expenses of the 12 Reserve Banks and the Board of Governors. These operating costs totaled $2.0 billion in 1994, and increased by 48 percent from 1988 to 1994. This 48-percent cost increase exceeded the 25-percent inflation and the 17-percent increase in total federal discretionary spending that occurred during this period, and was somewhat less than the 51-percent increase in federal nondefense discretionary spending.

About 70 percent of the Federal Reserve's operating costs were for payment system and other financial services provided to banks and government agencies, about 20 percent were for regulatory activities, and about 10 percent were for monetary policy activities. Pay and benefits for the Federal Reserve's workforce of over 25,000 employees accounted for almost 70 percent of its operating expenses.

As shown in table 1, over 10,000 Federal Reserve employees were involved with providing services to financial institutions and government agencies, over 5,000 were in support activities, and over 5,000 were in overhead. Thus, over 20,000 Federal Reserve employees—almost 80 percent of the System's total staff—were involved with support activities, overhead, or financial services. Monetary and economic policy activities and the Board of Governors staff accounted for only about 2,300 employees—or less than 10 percent of the System's total staff. And despite increasing almost 40 percent from 1988 to 1994, only about 3,000 Federal Reserve employees—or about 12 percent of the total staff—were involved with bank supervision and regulation in 1994.

Table 1: Federal Reserve Staffing by Activity, 1994

Category	1994 staffing level	Percentage of total
Board of Governors[a]	1,635	6%
Reserve Banks, by activity		
Monetary and economic policy	729	3
Services to Treasury and other agencies	1,754	7
Services to financial institutions	8,302	32
Supervision and regulation	3,079	12
Support (includes data processing, occupancy, printing, supplies, central planning services, district projects, etc.)	5,062	20
Overhead (includes administrative services, system projects, mail, legal, general books and budget, personnel, audit, protection, purchasing, motor vehicles, library, telephone, etc.)	5,183	20
Total Reserve Bank staffing	**24,109**	**94**
Total	**25,744**	**100%**

Note: Table staffing numbers reflect the average number of persons.

[a]System accounting does not allocate Board staffing by mission-related activity.

Source: Federal Reserve System.

As its staffing composition clearly indicates, the main workload of the Federal Reserve is not policymaking or bank supervision. Rather, it is oriented toward the production of financial services, whether paper driven, such as processing currency and clearing checks for banks, or electronic in nature, such as running an automated clearing house and funds transfer system. And it is precisely these major lines of business where we found that the Federal Reserve faces a number of growing pressures and challenges.

For example, as a result of increasing competition from private sector suppliers and a continued shift to electronic banking, the Federal Reserve has experienced a decline in the volume of its check-clearing activity and its market share. As table 2 shows, the Federal Reserve's costs have been rising faster than corresponding revenues in several of its other major service lines as well, and we found that the System did not meet its cost recovery target for its priced services overall in 1994. The major consolidation that is currently occurring in the banking industry could further reduce the demand for the Federal Reserve's financial services and significantly affect the magnitude and distribution of the Federal Reserve's supervisory activities as well. In particular, changes in the number and location of the bank-holding companies the Federal Reserve examines could require adjustments in the examination staffs of the various Reserve Banks.

Table 2: Percentage Changes in Revenue and Expenses for Payments for Federal Reserve Services, 1990-1994

Service	Revenue	Expenses
Check clearing	–.2%	13.8%
ACH	22.0	41.1
Fedwire	12.0	25.8

Legend: ACH = automated clearinghouse.

Source: Federal Reserve System.

In addition to reexamining the allocation of its supervisory resources, the Federal Reserve may also wish to rethink the way it conducts bank supervision. Rather than simply increasing the number of examiners when its responsibilities increase, the Federal Reserve could look for ways to make more effective use of private sector resources. In our recent review of five foreign bank regulatory structures, we found that all but one of these countries used the work of banks' external auditors as an important source of supervisory information.[3] While external audits would not necessarily replace bank examinations, the work of external auditors could be used to supplement and guide examinations and could enhance the efficient use of examination resources. Achieving some consolidation of the four federal banking regulators, as we have recommended, could also achieve greater efficiencies in the use of supervisory and regulatory resources.[4]

Many of the inefficiencies that we found at the Federal Reserve relate to its decentralized nature, which allows each Reserve Bank to set many of its own policies, and to the absence of traditional cost-minimizing forces that are commonplace in entities that are either purely private or public sector in nature. We also found that the Federal Reserve retained a $3.7 billion surplus account that we believe could be safely reduced or returned to the Treasury. While there are many areas that have some

[3]Bank Regulatory Structure: Canada (GAO/GGD-95-223, Sept. 28, 1995); Bank Regulatory Structure: France (GAO/GGD-95-152, Aug. 31, 1995); Bank Regulatory Structure: The Federal Republic of Germany (GAO/GGD-94-134BR, May 9, 1994); Bank Regulatory Structure: The United Kingdom (GAO/GGD-95-38, Dec. 29, 1994); and Bank Regulatory Structure: Japan, which is currently a draft report.

[4]Bank Oversight: Fundamental Principles for Modernizing the U.S. Structure (GAO/T-GGD-96-117, May 2, 1996), statement of James L. Bothwell.

cost-saving potential, we believe that achieving major cost reductions ultimately depends on the Federal Reserve carefully reexamining its mission, structure, and work processes.

The need for increased cost consciousness is heightened when one considers the degree of budgetary stringency that the federal government is projected to face in the next few years. If total discretionary spending is held to the levels envisioned in this year's congressional budget resolution, spending will fall by almost 6 percent between 1995 and 2002. Adjusting for projected inflation, this means that, in the year 2002, federal agencies as a whole will have about 22 percent fewer real resources than they had in 1995. It will be difficult to exempt the Federal Reserve, one of the larger federal entities in terms of employment, from bearing its share of this planned reduction.

For the Federal Reserve to most effectively meet these challenges and streamline its operations, we believe the Board of Governors and the Reserve Banks must work together to strategically plan for the future. Our prior reviews of public and private sector organizations that have successfully faced similar challenges and achieved truly significant cost savings, indicated that these organizations effectively implemented initiatives that focused on their primary missions and business lines, realigned their structures to fit their missions, and applied modern technology to streamline their work processes. If the Federal Reserve is to effectively follow this strategy, it will need the Board's sustained leadership and the Reserve Banks' commitment. The Federal Reserve will also need to address certain weaknesses that we identified in its existing oversight and budgetary processes.

Mr. Chairman, the Federal Reserve has begun to show that it can address operational issues strategically and work in a systemwide manner when necessary. As the Federal Reserve enters the next century, we believe that it needs to continue these efforts so that it can successfully meet the current and future challenges that it faces and accomplish its vital mission as efficiently and effectively as possible. Specifically, we recommend that the Board of Governors undertake a fundamental review of the Federal Reserve's operations that focuses on the primary mission, business lines, and structure that would best support its overall mandate.

Such a review of the System will present a challenge to the Federal Reserve because it is always difficult for an organization to ask basic questions about itself and to think about its future in a fundamentally new way. As a result, the Federal Reserve may want to call in outside experts to help it perform its review, which is an approach taken by many private sector enterprises.

Because the Federal Reserve would need congressional approval to act on some of these matters, we also suggest that Congress consider the results of the Board's assessments and determine what changes to the Federal Reserve's operations and structure would be desirable. While we believe it is particularly important not to make any changes that would threaten the independence of our nation's central bank in setting monetary policy, we also believe that there is no inherent conflict between this independence and efforts to improve the efficiency and effectiveness of the Federal Reserve's operations.

Mr. Chairman, this concludes my prepared statement. We would be happy to answer any questions that you or the other Members may have.

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