

### Banking, democracy and the critical balancing of power

**B**oth the financial crisis and the way it was handled by policymakers have generated substantial anger and frustration with our nation's financial system. Many, including me, believe there are important questions about how a nation that believes so strongly in capitalism can intervene to protect some who assumed excessive risk simply because of their size and "interconnectedness" while smaller firms are allowed to fail.

These are issues about how our markets are structured and function as well as several of the values Americans hold deeply, including fairness and honesty. In a nation where many of us are disgusted to see steroids taint the sports record books, the idea that the most powerful financial firms play by a different set of rules to similarly bolster their performance is an outrage. In many regards, it might seem that finding a way to avert the rules has become the true national pastime.

Despite the frustration many feel, I believe it is important to recognize that the arrogance and mistaken ideals of a few—albeit a very powerful and influential few—do not represent the broad population. And so, as we look at the financial crisis, it is important to point out that most bankers—in fact, almost all—play by the rules; are proud to serve their communities; and are perhaps the most dismayed about the crisis and how it was handled. Bankers, especially those at the community banks, are not the bad guys.

This is a reality that has seemingly been lost in the current national discussion about our financial system. Similarly lost have been the reasons why Congress, when it created the Federal Reserve nearly a century

ago, made a point of involving both bankers and the government in the oversight of our nation's central bank in such a manner that each balances the other. This balance is the Federal Reserve's real strength, and it is unfortunate that discussions about our financial system and the Fed's structure are happening in an era where opinions are largely shaped by sound bites, which are, by design, incomplete. Conducting much of this review at only a superficial level is not only tragic, but also dangerous for our national economic well-being over the long term. Politics is a short-term game, while decisions about monetary policy and how we regulate our financial institutions have substantial and far-reaching implications.

The most fundamental element to protecting our nation's democratic values is balancing power. The Federal Reserve, as an institution, is accountable to: the Congress, which created it; the administration, which appoints its chairman and governors; and the public, which it serves.

With this column, I would like to answer some of the most frequently asked questions about our nation's central bank and address some of the more widely held misconceptions on a full range of topics. In discussing these points, I think it will also illustrate not only how power and responsibility are distributed throughout the Federal Reserve, but also why it is so important to our nation.



## **Bankers do not control the Reserve Banks**

The Fed's congressional founders recognized the dangers of giving the government direct and sole control over the printing of currency. Because the public, including bankers, did not trust the politicians with the printing press, one-third of the seats on each board responsible for the oversight of the 12 Federal Reserve Banks are held by bankers. Bankers within each Federal Reserve District were given the opportunity to elect several local directors. However, two-thirds of the directors on a Reserve Bank's board are not permitted to be bankers.

While the public did not trust politicians, the politicians also recognized the risk in giving control to bankers. At the time of the Fed's founding, the nation had already made two attempts at a central bank, and neither one was successful because they were privately held institutions. To block private interests from controlling the central bank, a government agency known today as the Board of Governors was created and given broad oversight for the entire System. The governors are appointed by the president of the United States and confirmed by the U.S. Senate. Among their numerous responsibilities, the governors appoint one-third of the directors of each regional Federal Reserve Bank, including both the chair and deputy chair of each board.

With this structure, the Federal Reserve has the most grassroots, representative structure of any federal entity because the Washington-based Board of Governors, a federal agency, has the benefit of 12 regional Reserve Banks that

are located on "Main Streets" all around the United States.

## **Director elections, appointments are a model of accountability**

Congress included provisions in the Federal Reserve Act governing director eligibility and selection, in addition to requirements that dictate the makeup of regional Reserve Bank boards. Reserve Bank directors meet legal requirements and practices that guide their eligibility and conduct. They are held accountable by law. They come from diverse backgrounds within every region of the country and every sector of the economy: business, industry, labor, agriculture and banking. The Federal Reserve Board recently strengthened its rules to address Reserve Bank director eligibility in light of changes in the status of affiliated financial firms as occurred during the financial crisis, such as when investment banks quickly became bank holding companies.

Each Reserve Bank has nine directors:

- Three directors of each Reserve Bank board are appointed by the Board of Governors, the government agency. These directors are prohibited from any involvement in banking, including stock ownership, and are the only directors eligible to be chair and deputy chair.
- Three directors who are not bankers are elected by bankers from within their respective Federal Reserve district. These directors have no reporting responsibilities to any banks.
- Three directors who are local bankers within the region are elected by their peers. Regulations mandate that smaller banks must

hold two of these seats. Often in the Tenth Federal Reserve District, all three banking positions are held by individuals affiliated with community banks.

Federal Reserve Bank stock is owned by state-chartered member banks and all federally chartered banks. These bankers do participate in elections and may serve as directors. The percentage of stock they are required to own, and the dividend paid on that stock, is prescribed by law, thereby eliminating any incentive or reward to benefit from Reserve Bank operations.

Directors receive only travel reimbursement for meetings and a modest stipend. There is no meaningful monetary incentive to serve as a director.

A recent example of a director conflict that may be the source of public concern involved Stephen Friedman, former chairman of the Federal Reserve Bank of New York who also was the former chairman and a large shareholder of Goldman Sachs.

There are a few points about Mr. Friedman that may not be widely known, but are a matter of public record:

- Mr. Friedman was not elected by bankers to serve on the Federal Reserve Bank of New York's board. He was, in fact, appointed to his position at the New York Fed by the Board of Governors in Washington.
- Mr. Friedman later became ineligible for Federal Reserve service when Goldman Sachs was made a bank holding company as approved by the Board of Governors in Washington.
- Mr. Friedman, however, was allowed to continue to serve on the New York Fed board under a waiver of the rules that was granted

by the Board of Governors in Washington. He resigned from the position in the spring of 2009.

Directors have no role in banking supervision. As the central bank, the Fed plays a role in banking supervision. The bankers on Reserve Bank boards provide valuable insight on banking conditions and the general economy but are prevented by strict controls from any involvement in the Reserve Bank's supervisory role. There is no conflict.

Though Reserve Bank directors have important oversight responsibilities for the operation of their respective Reserve Bank, they have absolutely no role in banking supervision. By law, the Board of Governors is responsible for the supervision of banks, and any information or discussion related to supervisory issues moves directly between the regional Reserve Banks' staff and the Board in Washington. The Federal Reserve supervises all bank holding companies, so it is a misnomer that directors can put their own firm under Fed supervision for favorable treatment. If a bank director wants to convert his or her bank to Fed membership, the Board of Governors in Washington must act on the proposal and other agencies comment. When a Reserve Bank director who is a banker comes under a supervisory action, he or she typically resigns from the Reserve Bank's board.

## **Reserve Bank directors have no role in monetary policy voting**

The Federal Reserve has important protections in place to keep the banking community from becoming intertwined



with monetary policy votes. All Reserve Bank directors play an important role in the monetary policy process by providing economic and financial industry data that helps a Reserve Bank president understand current conditions. However, directors play no role in dictating how that president votes on the federal funds rate.

Reserve Bank directors, including bankers, do vote on the discount rate, which is the rate at which the Federal Reserve lends funds to financial institutions, but the rate must be ratified by the Board of Governors before it takes effect. Therefore, there is full control over the rate charged by the Federal Reserve Banks to the banking industry. In my view, there is extreme risk of some group or sector attempting to assert influence if this structure is put under greater political control.

### **Reserve Bank presidents vote on the FOMC, have political checks and balances**

Political appointees have the majority vote on the Federal Open Market Committee (FOMC). However, in designing the Fed's structure, Congress nearly a century ago recognized that it was important for views from a wide range of the public to contribute to important decisions. One of the most common complaints about any government agency or initiative, without regard to topic or political party, is that it is created entirely "inside the Beltway" and not connected to the concerns of the rest of the nation. The Fed's structure addresses this issue very directly.

When the modern FOMC was formed

some 20 years after the Fed's creation, this design was also reflected in its structure, with the Federal Reserve governors given a majority—seven of the FOMC's 12 voting seats. To suggest that only government appointees should be allowed to vote is, frankly, extremely dangerous from a policy perspective. However, the suggestion that government appointees are somehow free of other conflicts and considerations compared with the Reserve Bank presidents is false. One need only look to the U.S. Treasury and the various connections held by Goldman Sachs to see that, ultimately, any government appointee is a private citizen with a background and perhaps some concern about the opportunities in their future. The real question is: Are adequate protections in place?

It could be argued that the Reserve Bank presidents are far more insulated from financial interests than any elected or appointed official who can step directly into their post from the private sector. An examination of the current 12 regional Federal Reserve Bank presidents shows that six have come to their position after lengthy careers at the Fed, having moved up through the ranks. This means that their activities and personal investments have been heavily restricted for much—and in some cases all—of their professional lives. Three presidents have come to their positions at the Fed after extensive careers in academia. The remaining three presidents have backgrounds in banking and finance, but have also either held other posts within the Federal Reserve, or have spent time in public service or academia.

Reserve Bank presidents, though chosen by their boards of directors, may be vetoed by the Board of Governors. That is, they may be

prevented from serving if they are unsuitable, regardless of their selection by Reserve Bank directors.

Reserve Bank presidents undergo an annual review. This review involves both the Board of Governors and the local board of directors.

Reserve Bank presidents must be reappointed to their jobs every five years by their Bank's Board of Directors.

## **The Fed is transparent, accountable**

The Federal Reserve undergoes a wide range of audits and reviews involving the Board of Governors, the Government Accountability Office, the Treasury, an independent outside auditor and an internal auditor. Finally, the Fed is directly accountable to Congress, and Federal Reserve officials testify before Congress regularly.

The author of the so-called "audit the Fed" amendment has played down these numerous reviews in seeking support for his initiative. Congressman Ron Paul's goal is not a review of the central bank but, as is evidenced by the title of his most recent book, to "end the Fed." For those who see that as a desirable outcome, it is important to note that our nation was without a central bank for eight decades. Even a quick review of U.S. economic history shows this was a period of recurring financial crises as the nation wrestled with, among other problems, the pitfalls created by an inelastic currency whereby liquidity issues, rather than being addressed, could quickly bring about near economic collapse. Additionally, without

elasticity, credit could be unavailable to smaller banks that serve the broad population and tightly controlled by the largest institutions.

The Federal Reserve's structure was specifically crafted by Congress to limit the influence of financial and political interests on the nation's central bank. It is the direct result of the nation's populist movement and the desire to carefully balance competing interests. It is a structure that Congress has repeatedly supported. If anything, the events of the past year have convinced me that this delicate balance is at least as important—if not more—as it was when the Fed was created nearly a century ago.



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The book "**The Balance of Power**" summarizes the Federal Reserve's political history. Read it online at [KansasCityFed.org](http://KansasCityFed.org).