CONFERENCE OF STATE BANK SUPERVISORS

The Composition of the Federal Reserve Board of Governors

A historical perspective on the forces affecting the composition of the Federal Reserve Board of Governors

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About this Paper

This paper discusses aspects of the history of the Federal Reserve Board of Governors related to the composition of the Board of Governors and the evolution of the Federal Reserve's responsibilities. The paper highlights two key themes: i) the Federal Reserve's supervisory mandate has grown substantially since its inception; and ii) Congress has continually sought to ensure that the composition of the Board of Governors reflects a broad range of perspectives. Both of these themes point to the importance of ensuring that the Board of Governors includes individuals with an understanding of bank supervision.

In conjunction with this paper, CSBS is releasing an infographic (available at http://goo.gl/eCKVrS) that illustrates the evolution of the Board of Governors in terms of the backgrounds and experience of the individual governors. The infographic shows that the Board's composition in recent decades has become more monolithic in expertise and background and less reflective of a broad range of perspectives – this despite repeated Congressional mandates to the contrary.

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Introduction

As the Federal Reserve System celebrates its Centennial, the Obama Administration faces the task of filling several vacancies on the Board of Governors (the Board). The individuals named to fill these positions will shape financial policy at a crucial time as the economy continues an uneven recovery from the recent financial crisis and financial regulators proceed down the path of implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

With these vacancies on the Board in mind, this paper discusses two key themes of the Federal Reserve's 100-year history: the growth of the Federal Reserve's supervisory role and Congress's continuing efforts to ensure that the Board membership and activities reflect a broad range of perspectives. Both of these themes point to the importance of ensuring that the Board of Governors includes individuals with an understanding of supervision. Failure to ensure that the Board of Governors has members with knowledge of supervision would adversely affect the Federal Reserve's ability to fulfill its responsibilities and would run contrary to the language and intent of the Federal Reserve Act.

Creation of the Federal Reserve System

Until the early part of the 20th century, the United States banking industry developed and grew mostly in the absence of any national regulatory structure. Though the National Banking Act in 1863 authorized nationally chartered banks and established a regulatory regime for national banks, the National Banking Act created no central banking regime.[1]

During the post-Civil War Era, the U.S. financial picture was characterized by inelastic currency and immobile reserves.[2] These twin problems caused the economy to fluctuate wildly and unpredictably between booms and busts.[3] Financial panics occurred with some frequency. In 1893 the U.S. suffered a massive depression.[4] Additionally, a severe financial panic in 1907 forced about 25 banks and 17 trust companies into failure.[5] After the 1907 panic had run its course, commodity prices had fallen 21 percent, bankruptcies had spiked by 47 percent, and unemployment had risen from 2.8 to 8 percent.[6]

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[1] Roger T. Johnson, *Historical Beginnings…The Federal Reserve*, Federal Reserve Bank of Boston, p. 12-14 (February 2010).
[2] *Id.* at p. 14.
[3] *Id.*
[4] *Id.* p. 15.
[5] Robert Bruner and Sean Carr, *The Panic of 1907: Lessons Learned from the Market's Perfect Storm,* John Wiley & Sons (2007), *summary at* Financial History Magazine (Fall 2007) *available at* http://www.moaf.org/publications-collections/financial-history-magazine/89/_res/id=sa_File1/Article_89.pdf.
[6] *Id.* at p. 142.

Aldrich Plan

In an effort to understand and respond to the causes of the 1907 panic, Congress passed the Aldrich-Vreeland Act in 1908. Among other things, the Aldrich-Vreeland Act established the National Monetary Commission.[7] This body, composed of nine senators and nine House members, was directed to conduct a study and make banking reform recommendations.[8]

Included in the Commission's report, submitted in January of 1912, were recommendations commonly referred to as the Aldrich plan.[9] The Aldrich plan, named after the Commission's Chair, Senator Nelson Aldrich (R-RI), provided for one central institution, to be called the National Reserve Association, with branches all over the country and with the power to issue currency and rediscount the commercial paper of member banks.[10] Control of the institution would rest with a board of directors made up mostly of bankers.[11]

The banking industry largely supported the Aldrich plan because it gave the industry control over the central bank.[12] Conversely, progressives opposed the Aldrich plan over concerns that the plan provided for inadequate public control of the banking system, would enhance Wall Street's influence, and could be dangerously inflationary.[13]

Pujo Hearings

In 1912 and 1913, Congress conducted a series of hearings, held partly in response to the Aldrich plan and to help guide reform in a more progressive direction.[14] The Pujo hearings, named after Rep. Arsène Pujo (D-LA), found the banking system was controlled by a small group of Wall Street elite, or the "money trust."[15] In its February 1913 report, the Pujo Committee said:

> "If by a 'money trust' is meant an established and well defined identity and community of interest between a few leaders of finance…which has resulted in a vast and growing concentration of control of money and credit in the hands of comparatively few men … the condition thus described exists in this country today."[16]

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[7] Johnson, *supra* at p. 16.
[8] *Id.* at p. 16-17.
[9] Report of the National Monetary Commission, Sen. Doc. No. 243, 62d Congress, U.S. Government Printing Office (January 9, 1912).
[10] Johnson, *supra*, at p. 18.
[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] John Singleton, *Central Banking in the 20th Century*, Cambridge University Press, p. 53 (2011).
[15] Johnson, *supra* at p. 19.
[16] *Report of the Committee Appointed Pursuant to House Resolutions 429 and 504 to Investigate the Concentration of Control of Money and Credit*, U.S. House of Representatives, 62d Congress, Report No. 1593, p. 130 (February 28, 1913).

The Pujo hearings also illustrated the need for enhanced supervision of the nation's banks: national bank examiners, clearing-house examiners (private examiners), and state examiners were all competing for the same information and coordination was spotty. Comptroller of the Currency Lawrence Murray bemoaned the state of supervision in testimony before the Pujo Committee. "The whole question of bank examination is illogical, unscientific, and simply impossible under the present laws."[17]

President Wilson and the Federal Reserve

With the benefit of the Pujo hearings and reaction to the Aldrich plan, President Woodrow Wilson unveiled his outline for reform in a June 1913 appearance before a joint session of Congress.[18] President Wilson's plan was largely based on a proposal from Rep. Carter Glass (D-VA), who was Chairman of the House Committee on Banking and Currency and instrumental in the Federal Reserve's creation. President Wilson's plan called for the creation of privately controlled regional reserve banks, which would hold a portion of member banks' reserves, perform other central banking functions, and issue currency against commercial assets and gold.[19]

Asserting the importance of national control by public officials, President Wilson also insisted upon a central board to be the supervising authority over the system and to control and coordinate the work of the regional reserve banks, what he called the "capstone" to the entire structure.[20] The central board – the Federal Reserve Board — was to be a public agency in strong contrast to the industry dominated board envisioned by the Aldrich plan.[21]

The banking industry, having favored the Aldrich plan of a central bank under banker control, disliked a framework of government regulation dominated by political appointees.[22] Conversely, progressives, who preferred a strong role for the government to regulate perceived Wall Street excess, largely favored President Wilson's proposal.[23]

The Federal Reserve Act and the Early Composition of the Federal Reserve Board

From its inception and throughout its 100-year history, diversity has been a hallmark of the Board's composition and the entire system's structure. Repeatedly, Congress sought to bring multiple perspectives to the Federal Reserve System and to ensure that a broad range of experience and interests would be represented on the Board of Governors.

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[17] *Id*. at p. 20.
[18] Johnson, *supra* at p. 24.
[19] *Id.* at p. 21.
[20] James Neal Primm, *A Foregone Conclusion: The Founding of the Federal Reserve Bank of St. Louis*, *Volume I*, p. 23 (1989) *available at* http://www.stlouisfed.org/foregone/.
[21] Johnson, *supra* at p. 21.
[22] *Id*. at p. 24.
[23] *Id*. at p. 17-25.

The Federal Reserve Act (the Act), signed into law in December 1913, incorporated elements of the Wilson and Aldrich plans, creating a largely decentralized hybrid system of private and public entities. There were to be at least eight, and no more than 12, private regional Federal Reserve banks (12 were established), each with its own branches, board of directors, and district boundaries.[24]

This system was to be headed by a seven-member Federal Reserve Board made up of the Secretary of the Treasury, the Comptroller of the Currency, and five public officials appointed by the president of the United States and confirmed by the Senate.[25] The Federal Reserve Board and the Office of the Comptroller of the Currency both had authority to supervise and examine member banks.[26] The Act also created a single new United States currency, the Federal Reserve Note.[27]

The Act explicitly provided for diversity on the Board, stipulating that no more than one of the five presidentially appointed members was to be from any one Federal Reserve District and that the president of the United States, in naming members of the Board, should have "due regard to a fair representation of the different commercial, industrial and geographic divisions of the country."[28] Additionally, the Act required that at least two Board members were to be "persons experienced in banking or finance."[29]

These requirements for Board composition were intended to limit political influence on the Board and to help ensure that it would not be dominated by any one interest group or region.[30] In particular, Congress wanted to avoid giving substantial control to New York financial interests.[31]

Congress was adamant about ensuring diversity and regional participation in Federal Reserve decision making as a counterweight to centralized control. House Committee on Banking and Currency Chairman Glass (D-VA) called for the creation of 20 or more regional Reserve Banks in an early draft.[32] In a later account detailing the drafting and passage of the Federal Reserve Act, Glass wrote:

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[24] 12 USC § 222 and 223.
[25] 12 USC § 241.
[26] Kenneth Spong, *Banking Regulation: Its Purposes, Implementation and Effects, Fifth Edition,* Federal Reserve Bank of Kansas City Division of Supervision and Risk Management, p. 21 (2000).
[27] 12 USC § 411.
[28] Sayre Dykes and Michael Whitehouse, *The Establishment and Evolution of the Federal Reserve Board: 1913-1923,* Division of Research and Statistics at the Board of Governors and Board's Office of the Secretary, Federal Reserve Bulletin, p. 228 (April 1989).
[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] *A History: The Federal Reserve Bank of Atlanta 1914-1989*, Federal Reserve Bank of Atlanta, *available at* http://www.frbatlanta.org/pubs/atlantafedhistory/a_history_ofatl_fed-origins_ofsystem.cfm.

> "In the United States, with its immense area, numerous natural divisions, still more numerous competing divisions, and abundant outlets to foreign countries, there is no argument, either of banking theory or of expediency, which dictates the creation of a single central banking institution, no matter how skillfully managed, how carefully controlled, or how patriotically conducted."[33]

In response to the Depression of 1920-1921 after World War I, which hit agriculture particularly hard, Congress enacted various reforms, including a change to the Federal Reserve Act in 1922 that added a requirement for agricultural representation and removed the requirement that at least two Board members have experience in banking or finance.[34] These changes still stand today, as the president, in appointing members to the Board, is required to give

> "due regard to a fair representation of the financial, agricultural, industrial, and commercial interests, and geographical divisions of the country."[35]

Similarly, the statutory provisions related to the Federal Reserve Banks' boards of directors require diversity in terms of consideration of the various industries and interests. Each board includes representation of member banks as well as "the public," which can include interests such as "agriculture, industry, services, labor, and consumers."[36]

Subsequent changes made by the Banking Act of 1933, the Banking Act of 1935, and 1942 amendments to the original Federal Reserve Act brought the Federal Reserve System to its present structure:[37]

- The Secretary of the Treasury and Comptroller of the Currency were removed from the Board of Governors;[38]
- Board of Governor member terms were increased from 10 to 14 years;[39]
- The Board of Governor members appointed by the president was increased from six to seven;[40]
- The current position of president at each of the regional Federal Reserve Banks was established;[41]

[33] Tim Todd, *The Balance of Power: The Political Fight for An Independent Central Bank, 1790-Present,* Federal Reserve Bank of Kansas City, p. 12 (2012), *citing* Carter Glass, *An Adventure in Constructive Finance New York*, Doubleday, Page and Co., (1927).
[34] Alan Meltzer, *A History of the Federal Reserve, Volume 1: 1913-1951*, The University of Chicago, p. 74 (2003).
[35] 12 USC § 241.
[36] 12 USC § 302.
[37] David Fettig, Arthur J. Rolnick, David E. Runkle, *The Federal Reserve's Beige Book: A better mirror than crystal ball*, Federal Reserve Bank of Minneapolis (March 1, 1999) *available at* https://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3568.
[38] 12 USC § 241. The Secretary of the Treasury and the Comptroller of the Currency were to statutorily serve as members of the Board until February 1, 1936.
[39] 12 USC § 241.
[40] 12 USC § 241.
[41] 12 USC § 341.

- The Board of Governors was given overall responsibility for management of Board duties and functions;[42]
- The Chairman of the Board of Governors was given an executive role;[43] and
- The Federal Open Market Committee (FOMC) was created with its current voting structure which consists of the seven members of the Board of Governors, the president of the New York Federal Reserve Bank, and four other Reserve Bank presidents who serve on a rotating basis.[44]

Diversity in the Structure of the Federal Open Market Committee (FOMC)

Congress's emphasis on diverse perspectives in the Federal Reserve's work is also evident in the structure of the FOMC, a committee within the Federal Reserve charged with overseeing the nation's open market operations (i.e., the Federal Reserve's buying and selling of United States Treasury securities). It is this Federal Reserve committee that makes key decisions about interest rates and the growth of the United States money supply to accomplish the goals of promoting economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

The breadth of these goals alone speaks to the need for the Board and the FOMC to reflect the country's and the economy's diversity. Congress, in structuring the FOMC, recognized this need and met it by requiring participation in the FOMC of a rotating subset of regional Reserve Bank presidents.

Moreover, the Federal Reserve's supervisory responsibilities help inform its conduct of monetary policy. In arguing on the Senate floor in support of a bi-partisan amendment to preserve the Federal Reserve's authority over state-chartered banks and bank holding companies with less than $50 billion in assets, Sen. Kay Bailey Hutchison (R-TX) stressed the importance of the connection between supervision and monetary policy:

> "When the Federal Reserve was established, there was a debate about whether we would have regional offices or whether there would just be the Federal Reserve Board sitting in Washington. The decision was made to have Federal banks in key parts all over the country that would be regional banks. The purpose was that we needed to know what was happening all over the country, not only in New York, not only in Washington, DC, but throughout the country, because it is the community banks that are the depository institutions that are the mainstay of our economy and our financial community. If you take the Federal Reserve supervisory authority away from all those community banks around the country and regional banks no longer have input into what

[42] 12 USC § 241.
[43] 12 USC § 242.
[44] 12 USC § 263(a).

is going on in smaller communities, we will have too big to fail in reality, and we will also have a monetary policy that is going to cater to the big financial institutions…"[45]

The Growth of the Federal Reserve's Supervisory Functions

Starting with its supervisory responsibility over state members banks, which was initially shared with the Office of the Comptroller of the Currency, the Federal Reserve's supervisory responsibilities have continued to expand over time and largely in response to crises. Today, the Federal Reserve is responsible for supervising and regulating bank holding companies (including diversified financial holding companies under the Gramm-Leach-Bliley Act) and thrift holding companies and state-chartered banks that are members of the Federal Reserve System. The Federal Reserve supervises corporations through which U.S. banks conduct operations abroad,[46] as well as the U.S. operations of foreign banks.[47] In addition, under the Dodd-Frank Act, the Federal Reserve regulates non-bank systemically important financial institutions (SIFIs) identified by the Financial Stability Oversight Council (FSOC).[48] The Board of Governors delegates many supervisory duties to the 12 Reserve Banks subject to the Board's policy and oversight.[49]

Regulation and Supervision of Bank Holding Companies

In response to the Great Depression, Congress passed the Banking Act of 1933, commonly-referred to as Glass-Steagall.[50] In addition to separating commercial and investment banking and making governance and structural changes to the Board, the Banking Act of 1933 brought under Federal Reserve supervision all bank holding companies (BHCs) that contained a member bank.[51]

However, there were loopholes in the 1933 Act. In particular, holding companies could evade branching laws and restrictions on the mixing of banking and commerce.[52] After conducting oversight hearings, Congress responded by passing the Bank Holding Company Act of 1956, which placed restrictions on BHC activities and expanded the Federal Reserve's authority over the activities and formation of BHCs.[53]

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[45] 156 Cong. Rec. S3521-3522 (statement of Sen. Kay Bailey Hutchison "To maintain the role of the Board of Governors as the supervisor of holding companies and State member banks.") (May 11, 2010).
[46] 12 USC § 611-631.
[47] 12 USC § 3105.
[48] 12 USC § 5361 and 5365.
[49] 12 USC § 248.
[50] *See, e.g.,* David H. Carpenter, Murphy, M. Maureen, *Permissible Securities Activities of Commercial Banks Under the Glass–Steagall Act (GSA) and the Gramm-Leach-Bliley Act (GLBA),* Congressional Research Service Report, R41181, (April 12, 2010).
[51] *See, e.g.,* Thomas Watkins and Robert Craig West, *Bank Holding Companies: Development and Regulation*, Federal Reserve Bank of Kansas City Economic Review, p. 4 (June 1982).
[52] J.P. Dreibelbis, *Legislative Program for Bank Holding Companies,* The Marriner S. Eccles Document Collection, 1-2 (1943) *available at* http://fraser.stlouisfed.org/docs/historical/eccles/017_06_0002.pdf.
[53] S. Rep. No. 1095, 84th Cong., 1st Sess. (1955).

Regulation and Supervision of Foreign Banking Organizations (FBOs)

In the same manner that the Federal Reserve's supervisory responsibilities over domestic financial institutions have expanded over the course of the Federal Reserve's history, Congress has also increased the Federal Reserve's regulatory and supervisory responsibilities over foreign banking organizations. Today, the Federal Reserve examines FBO branches, agencies, commercial lending companies, and affiliates.[54] The Federal Reserve, in its capacity as the central bank, also obtains information on the financial condition of the parent bank and meets regularly with the management of the FBOs operating in the United States.[55]

Prior to 1978, FBOs were primarily regulated and supervised by state banking regulators.[56] Moreover, FBOs were generally permitted to establish or acquire bank subsidiaries under either federal or state law, and to establish branches or agencies under state law.[57] By avoiding many of the federal restrictions applicable to domestic banking institutions, foreign banks arguably had a competitive advantage over domestic banks.[58] In response, Congress passed the International Banking Act of 1978 (IBA). The IBA established a new regulatory framework to govern FBOs. The central premises of this framework were the policy of "national treatment" and consolidated federal supervision by the Federal Reserve of all U.S. operations of foreign banks.[59]

Passed in response to the Bank of Credit and Commerce International (BCCI) scandal,[60] the Foreign Bank Supervision Enhancement Act (FBSEA) of 1991 augmented the Federal Reserve's supervisory responsibilities by requiring Federal Reserve approval for the establishment of both state-licensed and federally licensed branches and agencies and for certain activities of state-licensed FBO branches or agencies.[61]

Dodd-Frank and the Expansion of the Federal Reserve's Supervisory Authority

Despite bi-partisan and repeated criticism of the Federal Reserve's performance in the lead-up to the financial crisis, Congress – in developing and enacting the Dodd-Frank Act – preserved and even expanded the Federal Reserve's supervisory authority.[62] Not only did the Federal

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[54] 12 USC § 3105.
[55] William Taylor, Staff Director, Division of Banking Supervision and Regulation, *Federal Reserve Bulletin*, 76 Fed. Res. Bull. 12, p. 1032 (1990).
[56] Daniel Laifer, *Putting the Super Back in the Supervision of International Banking, Post-BCCI,* 60 Fordham Law Review 467, p. 475 (1992).
[57] *Id.*
[58] *Id.* at p. 475-476.
[59] *Foreign Banks: Assessing Their Role in the U.S. Banking System,* GAO Report GGD-96-26, p. 18 (February 1996).
[60] *See e.g., The BCCI Affair*, Senate Print 102-140, Senate Foreign Relations Committee, 102d Congress 2d Session, December 1992.
[61] 12 CFR § 211.29
[62] *Committee on Banking, Housing, and Urban Affairs: Establishing a Framework for Systemic Risk Regulation,* S. Hrg. 111-297 (July 23, 2009).

Reserve System preserve its authority over state member banks, the Federal Reserve – with the dissolution of the Office of Thrift Supervision (OTS) – gained supervisory authority of savings and loan holding companies.[63] Furthermore, the Federal Reserve was given supervisory authority over non-bank financial companies deemed systemically important by the FSOC.[64]

Demonstrating the importance of supervision to the Federal Reserve's overall mandate, Congress, in the Dodd-Frank Act, created the new position of Vice Chairman of Supervision on the Board of Governors. The Vice Chairman for Supervision "shall develop policy recommendations for the Board regarding supervision and regulation of depository institution holding companies and other financial firms supervised by the Board, and shall oversee the supervision and regulation of such firms."[65]

Former Federal Reserve Chairman Paul Volcker, in criticizing the failure to fill this position, captured the importance and intent of this provision in Senate testimony:

> "I call your attention to another piece of unfinished business. … [A] member of the Federal Reserve Board should be designated as Vice Chairman for Supervision. Supervision of the banking and financial system should have a strong and visible place on the agenda at the Federal Reserve."[66]

<u>Conclusion</u>

At the Federal Reserve's creation and through key reforms and changes during its 100-year existence, two themes emerge: its supervisory role has grown; and its governance has become more publicly accountable and representative of the country's geographic and economic diversity. Infused throughout Congress's work on the structure of the Federal Reserve is a strong Congressional intent to bring varying and multiple viewpoints to the Board and to avoid a monolithic entity tied too closely to the New York-Washington D.C. financial-political axis.

At key moments in our nation's financial history when responding to crises, Congress has consistently responded by augmenting the Federal Reserve's supervisory authority. The Dodd-Frank Act continued this trend in several important respects. First, it created a new position, the Vice Chairman for Supervision. Second, in the Dodd-Frank Act, Congress made a conscious decision to preserve the Federal Reserve's supervisory authority over state member banks. Finally, the Dodd-Frank Act vested the Federal Reserve with responsibility for overseeing non-bank financial institutions designated as systemically important.

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[63] 12 USC § 1467(a).
[64] 12 USC § 5361 and 5365.
[65] 12 USC § 242.
[66] *Subcommittee on Financial Institutions and Consumer Protection: Is Simpler Better? Limited Federal Support for Financial Institutions,* S. Hrg. 112-679 (May 9, 2012).

These two trends — enhancing the Federal Reserve's supervisory authority and the continuing emphasis of diversity in the Federal Reserve's governance — illustrate the importance of maintaining a tight connection between the Board of Governors and supervision. This can only be accomplished by naming individuals to the Board of Governors with an in-depth understanding of bank supervision.