United States General Accounting Office

GAO

Report to Congressional Requesters

September 2002

FEDERAL RESERVE SYSTEM

Update on GAO's 1996 Recommendations

GAO

Accountability ★ Integrity ★ Reliability

GAO-02-774

Contents

Abbreviations

FDIC	Federal Deposit Insurance Corporation
DRR	Designated Reserve Ratio
OCC	Office of the Comptroller of the Currency
PSDC	Payments System Development Committee

United States General Accounting Office
Washington, D.C. 20548

September 25, 2002

The Honorable Harry Reid
The Honorable Byron Dorgan
United States Senate

Our June 1996, report,[1] which we prepared at your request, made a number of recommendations to the Board of Governors of the Federal Reserve System (the Board) for reducing spending and improving the operations of the Federal Reserve System (Federal Reserve). This report responds to your request that we review the status of the Federal Reserve's response to our recommendations, which fall into four broad categories: (1) systemwide mission and management issues, (2) control and oversight mechanisms, (3) administrative functions, and (4) funding the cost of bank examinations. For each category, we briefly review the report's findings and recommendations and then describe related actions taken by the Federal Reserve following publication of the 1996 report.

The 1996 report also made a recommendation regarding the Federal Reserve's practice of maintaining a surplus account to protect the Federal Reserve from losses. We address this issue in a separate report.[2]

Results in Brief

The Federal Reserve has taken actions responsive to most of the 1996 report's recommendations. The Federal Reserve has retained its structure but has sought to consolidate operations and bring common management practices to the 12 Federal Reserve District Banks (Reserve Banks). In particular, the Federal Reserve now manages the payments services it provides to banks on a systemwide basis. The Federal Reserve has also changed its budgeting, internal oversight, and cost accounting processes in an effort to increase accountability. It has taken other steps to decrease costs in areas identified by our 1996 report. For example, the Reserve Banks have consolidated their purchases of some services, such as prescription drug coverage, to take advantage of volume discounts, rather than continuing with the former practice of each individual Reserve Bank

[1]U.S. General Accounting Office, *Federal Reserve System: Current and Future Challenges Require Systemwide Attention*, GAO/GGD-96-128 (Washington, D.C.: June 17, 1996).

[2]U.S. General Accounting Office, *Federal Reserve System: The Surplus Account*, GAO-02-939 (Washington, D.C.: Sept. 18, 2002).

purchasing services separately. The Federal Reserve, however, continues not charging for bank examinations. Federal Reserve officials explained that they continue to believe that charging for bank examinations would tip the current balance against state charters for banks, and thus be inconsistent with maintaining the dual banking system of state and nationally chartered banks. While we continue to believe that a strong argument exists for industry funding of federal supervision and regulation, we also recognize the benefits of the dual banking system. Ultimately, it is up to Congress to decide how to fund federal regulation and to balance the differences among the different bank regulators.

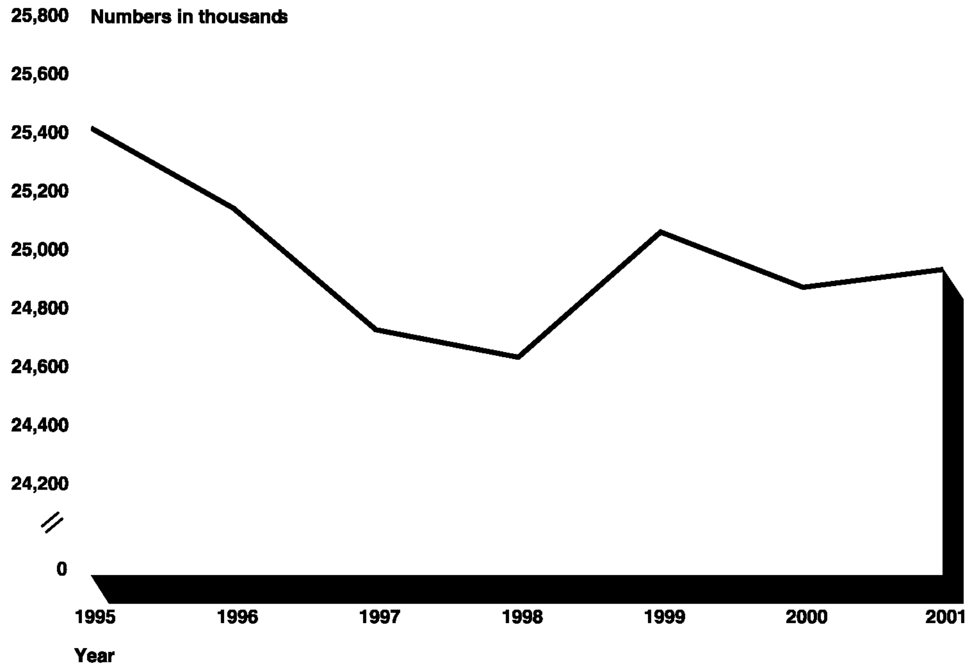
Background

The Federal Reserve Act of 1913 established the Federal Reserve System as the country's central bank. The act made the Federal Reserve an independent, decentralized bank to better ensure that monetary policy would be based on a broad economic perspective from all regions of the country. The Federal Reserve System consists of the Board of Governors located in Washington, D.C., and 12 Reserve Banks, with 25 branches, located throughout the nation.

Each Reserve Bank is a federally chartered corporation with a Board of Directors representing the public and member banks in its district. Under the Federal Reserve Act, Reserve Banks are subject to the general supervision of the Board. The Board is a federal agency, responsible for maintaining the stability of financial markets, supervising financial and bank holding companies and state-chartered banks that are members of the Federal Reserve and the U.S. operations of foreign banking organizations, and overseeing the operations of the Reserve Banks. The Board has delegated some of these responsibilities, including bank examinations, to the Reserve Banks, which also provide payment services, such as check clearing and wire transfers, to depository institutions and government agencies.

In 2001, there were approximately 25,000 staff in the Federal Reserve with about 93 percent of these employees working at the Reserve Banks. From 1995 to 2001, Federal Reserve employment decreased by 482 employees. Employment for 2002 is projected to grow by 314, largely because of plans to increase security staff. Figure 1 shows Federal Reserve employment from 1995 to 2001.

Figure 1: Federal Reserve Employment from 1995 to 2001



Source: Federal Reserve Board staff.

In the 1996 report, we noted that the Federal Reserve is self-financed, and that the income it collects but does not use to fund its operations is turned over to the U.S. Treasury.[3] In 2001, the Federal Reserve had a total income of $31.9 billion and expenses of approximately $2.1 billion; it subsequently transferred $27.1 billion to the U.S. Treasury.[4]

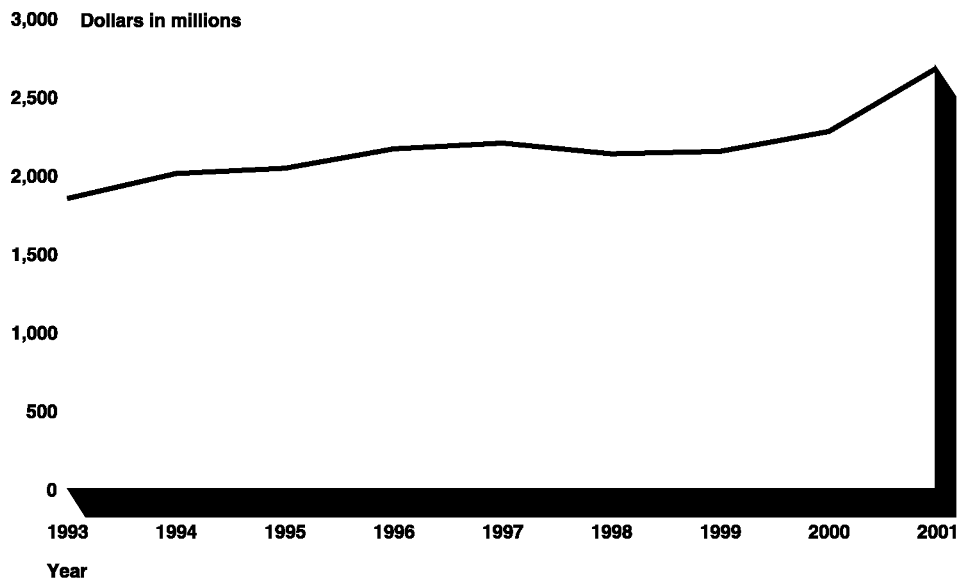
Since 1993, the operating expenses of the Federal Reserve have increased an average of 4.2 percent per year (2.2 percent when adjusted for inflation). According to its 2002 Budget Review, the Federal Reserve's operating

[3]The Federal Reserve earns most of its income from its portfolio of Treasury securities. It also receives revenue for payment services that it provides to financial institutions.

[4]The remaining $2.7 billion comprised net deductions from income resulting primarily from unrealized losses on assets denominated in foreign currencies revalued to reflect current market exchange rates; assessments by the Board for its expenses and cost of currency; and other distributions, which included dividends paid to member banks and transfers to the surplus account.

expenses are budgeted at $2.8 billion, an increase of 4.5 percent from the estimated 2001 expenses. Figure 2 shows the Federal Reserve's operating expenses from 1993 to 2001.

Figure 2: Federal Reserve Operating Expenses from 1993 to 2001



Source: Federal Reserve budget review.

Our 1996 report identified several inefficiencies in the Federal Reserve's policies and practices that had increased the cost of providing its services, including its costs for travel, personnel benefits, and contracting and procurement. Many of these inefficiencies related to the decentralized nature of the Federal Reserve, which allowed each Reserve Bank to set many of its own policies, and to the absence of traditional cost-minimizing forces, such as competition or appropriations, that are commonplace in entities that are either purely private or public sector in nature. With this in mind, we suggested that the Federal Reserve could do more to increase its cost consciousness and ensure that it is operating as efficiently as possible.

The 1996 report concluded that major cost reductions ultimately depended on the Federal Reserve's carefully reexamining its mission, structure, and work processes. The report identified areas that had potential for reducing the Federal Reserve's costs. The recommendations from the report fall into four broad categories:

- systemwide mission and management issues,
- control and oversight mechanisms,
- cost of specific Federal Reserve administrative functions, and
- charging banks for the costs associated with bank examinations.

The Federal Reserve Has Taken Steps to Address Systemwide Mission and Management Issues

In 1996, we noted that the Federal Reserve faces major challenges in its mission and lines of business, particularly in services to depository institutions and government agencies and in bank supervision. These challenges included (1) increased competition from the private sector and increasing difficulties in recovering costs in priced services; (2) increasingly widespread use of electronic transactions in the financial services industry; and (3) continuing rapid consolidation of the banking industry, which could affect both the need for and the distribution of bank examination staff. Because these areas accounted for the largest part of the Federal Reserve's expenses and staffing, we believed that addressing these challenges effectively would likely result in major changes in how the Federal Reserve operated.

The Federal Reserve's strategic plans and programs under development at the time of the 1996 report generally focused on individual divisions, Reserve Banks, or functions. While these plans served an important purpose in defining the direction of these Federal Reserve entities, we also believed that the emerging issues and challenges facing the Federal Reserve would necessitate strategic planning focused on the system as a whole. We also found that each of the Reserve Banks administered various functions independently, rather than as a single entity that could operate more efficiently or possibly command more advantageous prices. These findings led to the recommendations in figure 3.

Figure 3: 1996 Recommendations Affecting Federal Reserve Systemwide Mission and Management Issues

GAO recommends that the Board undertake a fundamental review of Federal Reserve operations focusing on the primary mission, business lines, and structure that would best support its overall mandate. Such an organizational review should include an assessment of:

- the Federal Reserve's role in providing financial services to banks and government agencies and an analysis of the costs and benefits to the System and the taxpayers of various options for delivering such services (such options could include: discontinuing delivery of certain priced services to financial institutions; privatizing the delivery of other services by establishing a private corporation for delivering such services; or retaining responsibility for being the primary service provider);

- cost-saving opportunities that could result from streamlining its existing management structures and consolidating Federal Reserve operations, including possible mergers among the 12 Reserve Banks and 25 branches; and

- the potential for technology to support streamlined work processes in the Reserve Banks and reduce costs and improve quality.

Source: U.S. General Accounting Office, *Federal Reserve System: Current and Future Challenges Require Systemwide Attention*, GAO/GGD-96-128 (Washington D.C.: June 17, 1996).

Since 1996, the Federal Reserve has consolidated the management of the services provided by the individual Reserve Banks, particularly payment services. For example, payment system products and new technologies are now managed on a systemwide basis. The Federal Reserve also has undertaken an assessment of its role in providing payment services.

In January 1998, the Committee on the Federal Reserve in the Payments Mechanism, chaired by the Vice Chair of the Board of Governors, issued its report entitled *The Federal Reserve in the Payments Mechanism.* The study examined the payment services provided by the Federal Reserve in light of the rapid changes occurring in the financial services and technology sectors. These services include check clearing and automated clearinghouse services such as direct deposits. The committee undertook a fundamental review of the Federal Reserve's role in the payments system and considered how alternative roles for the Federal Reserve might enhance or undermine the integrity, efficiency, and accessibility of the payments system. It concluded that the Federal Reserve's current role, or even a slightly enhanced role, in fostering technical change was preferred by most payment system participants.

In July 1999, the Federal Reserve formed the Payments System Development Committee (PSDC) to advise the Board and system officials on medium- and long-term public policy issues surrounding developments in the retail payments system.[5] This committee, which includes two Federal Reserve Board Governors, a Reserve Bank President, and a Reserve Bank First Vice President, was intended to follow up on the work of the Committee on the Federal Reserve in the Payments System. PSDC's work has included the Check Truncation Act, proposed legislation designed to remove certain legal impediments to check truncation and enhance the overall efficiency of the nation's payments system. It has also worked with payments industry officials to develop standards to facilitate increased use of electronic check processing. The Federal Reserve has introduced new payment products, such as its imaging service, to recognize the increasing role that image-based services are playing in the evolution of the U.S. payments system and the migration toward more electronic payments.

The Federal Reserve has also undertaken numerous initiatives to streamline management structures, consolidate operations, and apply emerging technologies to the Reserve Banks' business processes in order to improve quality and reduce costs. Federal Reserve officials explained that many of their initiatives have the effect of consolidating functions of the Federal Reserve without consolidating the 12 Reserve Banks. For example, in 1999, the Treasury Direct customer support function was consolidated so that only 3 Reserve Banks are providing customer service support to individuals who purchase Treasury securities directly from the Treasury. From 1999 to 2002, the Federal Reserve consolidated several aspects of Fedwire funds and securities transfer operations. Similarly, in 2000, the Treasury Investment Program was implemented, centralizing services that the Federal Reserve provides to the Treasury Tax and Loan Program.

The Federal Reserve continues to standardize and centralize the management of computer applications used for common business needs. It has selected a central site to develop and implement a centralized application for the Reserve Bank Planning and Control System. The Federal Reserve estimates that the centralization of applications such as

[5]PSDC is cochaired by the Vice Chairman of the Federal Reserve Board and the President of the Federal Reserve Bank of Boston.

the budget application will result in systemwide savings of $2.6 million over a 5-year period.

The Federal Reserve Has Strengthened Its Control and Oversight Mechanisms

In 1996, we noted a number of weaknesses in the Federal Reserve's budgeting and internal oversight processes. In reviewing the budgeting process for both the Board and Reserve Banks, we found that it was based on a current services approach that assumed both that existing functions would be retained and that the budget would continue to grow incrementally. We concluded that such an approach did not adequately support top management in controlling costs and imposing the internal self-discipline necessary for the Federal Reserve to respond effectively to future priorities. We found that internal oversight processes, such as performance measurement, internal audit, and financial audits, either did not support performance evaluation from a systemwide perspective or were becoming increasingly inappropriate in the changing environment. We also noted that the Office of Inspector General was authorized to review the activities of the Board, but not the Reserve Banks. As a result, we concluded that the Federal Reserve might not be making the most use of its resources devoted to Federal Reserve oversight. These findings led to the recommendation in figure 4.

Figure 4: 1996 Recommendation Affecting Federal Reserve Control and Oversight Mechanisms

GAO recommends that the board strengthen its existing control and oversight mechanisms by, among other things, (1) reviewing the appropriateness of current budget assumptions that assume steady annual growth; (2) taking steps to better ensure the independence of the Federal Reserve's internal audit function and to expand the scope of its Inspector General's authority; and (3) ensuring that an independent financial audit of the Reserve Banks' combined financial statements is conducted every year.

Source: GAO/GGD-96-128.

In addition to incorporating systemwide business strategies and resource needs into the Federal Reserve Bank budget planning process, the Federal Reserve Banks have changed their cost accounting system and have altered their internal and external auditing practices.

The Federal Reserve recognized that its budget process required too much effort and yielded an unrealistic spending outlook. Therefore, the Federal

Reserve's Financial Support Office proposed changes to the budget process in which system budget targets would be based on systemwide guidance rather than on Reserve Bank projections of their expenses. Banks provided their expense information later in the process when their budget development would be further along—an approach that also could help align budget planning with goal-setting for business strategies. In 2001, the Federal Reserve's Conference of First Vice Presidents recommended incorporating this guidance to align the Reserve Bank budget projections more closely with business strategies. The conference identified "national business leaders," that is, Federal Reserve staff with responsibility for most Reserve Bank functions. These leaders provide business guidance as input to the Reserve Banks as they prepare their Reserve Bank Budget Outlook. They are responsible for almost 90 percent of the total Reserve Bank spending. (The remaining 10 percent of spending is largely in support of Federal Reserve monetary policy formulation and is not covered by systemwide budget goals.)

The Board of Governors has also redefined its strategic plan and has now implemented a more rigorous 4-year planning process and a 2-year budget process. With this new plan in place, the Board has consolidated overhead and several support functions to reduce costs.

In March 2000, the Conference of First Vice Presidents approved recommendations designed to improve the cost-accounting practices of the Federal Reserve Banks. Board staff told us that Reserve Bank staffs have implemented these recommendations. Changes, according to Board staff, include the following:

- Simplifying expense allocation by tying expenses to departments and organizational units in Reserve Banks rather than to specific activities. This change will eliminate a major portion of the manual process currently in place, and in turn, will reduce the opportunity for erroneous activity charges.
- Shifting some expenses from overhead to the service line that they support to reflect expenses more accurately.
- Eliminating sharing of costs among Reserve Banks for all services and operations that are provided centrally. Instead, the Reserve Bank that provides the service will now report associated expenses in an effort to enhance accountability.

The Board adopted several new policies aimed at safeguarding the independence of its external auditor. An external auditor, under a contract administered by Board staff, reviews each Reserve Bank's financial statements. To enhance independence, in May 2002, the Board placed restrictions on Reserve Banks' ability to contract with the Board's external audit firm or to hire an auditor that has worked on the audit of a Reserve Bank. The Board currently requires that the external auditor of the Reserve Banks remain independent of Reserve Bank management, and that it provide a written statement to the Board delineating all relationships between the external auditor and the Reserve Banks.

In 2001, the Board revised its policy on Reserve Bank audit committee duties and responsibilities, requiring that (1) audit committees adopt formal written charters, (2) audit committee members be independent and financially literate, and (3) audit committees meet with external auditors to discuss the Reserve Bank's financial statements and issues arising from the annual external audit. The audit authority of the Inspector General remains unchanged.

The Federal Reserve Has Consolidated Some of Its Administrative Functions

In 1996, we concluded that opportunities existed to reduce the Federal Reserve's spending in a number of different administrative areas. We found in 1996 that Federal Reserve personnel compensation (pay and benefits) varied within the Federal Reserve and included benefits that were relatively generous compared with those of government agencies with similar responsibilities.

We also found that the Federal Reserve's health care benefits were managed on a decentralized basis, with each Bank negotiating its own health care coverage. We noted that although the Reserve Banks had individually made efforts to reduce health care costs, the Reserve Banks had not worked together to determine whether their combined bargaining powers would further reduce these expenses.

We found in 1996 that travel policies differed between the Board and the Reserve Banks and among the Reserve Banks. Therefore, the same trip could present different costs to different Reserve Banks. The differing travel policies made it necessary for each Reserve Bank to manage its own travel costs rather than allowing the Federal Reserve to manage travel costs on a centralized basis.

We also found in 1996 that the Board and the Reserve Banks used different procurement guidelines. The Board, while not specifically directed to do so by the Federal Reserve Act, followed the spirit of the federal government contracting rules. The Reserve Banks were required to follow Uniform Acquisition Guidelines, which were adopted by the Reserve Banks in 1985. These guidelines were designed to provide minimum requirements for Reserve Bank procurement activities. By providing opportunities for all interested bidders to become a selected source, the guidelines attempted to ensure that Reserve Banks treated sources fairly and impartially. By fostering competition in the procurement process, Reserve Banks would have greater opportunity to realize cost savings through lower competitive pricing. Despite the Uniform Acquisition Guidelines, we observed instances in which

- practices at individual Reserve Banks differed significantly and some practices favored certain sources over others and

- proper controls over conflict of interest were not followed at certain Reserve Banks.

Practices at certain Reserve Banks lacked independent checks and reconciliations, and best practices used by certain Reserve Banks were not disseminated among the Reserve Banks. These findings led to the recommendations in figure 5.

Figure 5: 1996 Recommendations Affecting Federal Reserve Administrative Functions

- Review pay and benefit levels at the Board and the Reserve Banks to determine if these levels can continue to be justified, considering today's environment of increased governmental and private-sector cost containment and the composition of the Federal Reserve's workforce.
- Assess whether managing the Federal Reserve's health care coverage on a systemwide basis could reduce health care costs.
- Review travel policies at the 12 Reserve Banks and change those policies that increase costs.
- Review contracting and procurement practices at the 12 Reserve Banks to ensure that these practices are in compliance with the system acquisition guidelines and result in cost-effective contracts.
- Ensure that the "best practices" in contracting and procurement at the 12 Reserve Banks are regularly identified, disseminated, and adopted by the Reserve Banks.

Source: GAO/GGD-96-128.

The Federal Reserve has taken or begun a number of actions in response to the findings and recommendations in our 1996 report. These actions include reassessing the compensation approach for the Federal Reserve, consolidating health insurance for the Reserve Banks, and changing its travel and acquisition practices.

A work group of senior Reserve Bank and Board officials was established to reassess the compensation philosophy within the Federal Reserve System. The Board approved a new Reserve Bank total compensation philosophy on June 18, 1997. The philosophy provided broad principles for the design of benefit plans that were intended to be competitive within relevant labor markets and sufficiently flexible to attract, retain, and motivate the staff and officers required to fulfill the mission of the Federal Reserve. The policy indicates the purpose and objectives of Reserve Bank compensation and benefit programs as well as relevant labor markets and competitive position. In 1999, the Board approved in concept a Reserve Bank strategic benefits plan, which was developed to be a more specific plan for ensuring that benefits will be appropriately competitive into the future.

The Federal Reserve is in the process of consolidating the administration and selection of health benefits so that all Reserve Banks have similar plans that are administered uniformly. Initiatives in managing benefits also have led to the consolidation of the administration and record keeping of several other benefits, including the Thrift Plan, retirement plans, retiree prescription plans, and worker's compensation plans. According to Federal Reserve staff, the thrift and retirement plans were consolidated a number of years ago and are fully outsourced to a single vendor. Moreover, the Board's Office of Employee Benefits projects that it will save $4 million from implementing the consolidated health care plans.

In 2001, the Reserve Banks began a plan to reduce travel costs by upgrading videoconferencing capabilities. A vendor for this system was selected in the first quarter of 2002, and Federal Reserve officials said installation of new facilities has been completed in offices that previously had videoconferencing. The next phase of this effort will include installing videoconferencing facilities in offices that did not previously have them. The Board has also encouraged travel savings through pursuing government discounts and traveling at nonpeak hours.

In March 1997, the Federal Reserve completed a fundamental review of its Uniform Acquisition Guidance. As part of this effort, it reviewed benchmarking and best practices efforts to determine if any changes were necessary. In July 1998, a new Model Acquisition Guideline was approved, replacing the 1985 Uniform Acquisition Guidelines. The Federal Reserve has continued to engage in its benchmarking process. Federal Reserve staff said that this process has revealed continued declines in the cost of providing procurement services through the use of streamlined purchasing procedures. Benchmarking studies have concluded that the Federal Reserve's enhanced use of the System Purchasing Service to gain economies of scale has resulted in significant savings. Board staff explained that, where it makes sense, the Board uses procurement resources available to government agencies, such as the General Services Administration. However, they said that in some cases, such as in their procurement of telecommunication services, the Board and the Reserve Banks might negotiate together to enhance their bargaining position.

The Federal Reserve Has Continued Its Policy of Not Charging for Bank Examinations

Our 1996 report noted that the Federal Reserve's revenues, and hence its return to the taxpayers, would be enhanced by charging fees for bank examinations. Federal bank regulators differ in their policies regarding the assessment of fees for bank examinations. The Office of the Comptroller of the Currency (OCC) charges national banks for examinations that it conducts. In contrast, state-chartered banks, which are supervised by either the Federal Reserve or the Federal Deposit Insurance Corporation (FDIC) in conjunction with state banking agencies, are charged fees by those state banking agencies but not by their federal regulator. Thus, the costs of the Federal Reserve's federal bank examinations are borne by the taxpayers, while for national banks, the costs of examination are borne by the banks that are examined. The Federal Reserve Act authorizes the Federal Reserve to charge fees for bank examinations, but the Federal Reserve has not done so, for the state member banks it examines. In addition, the Federal Reserve inspects bank holding companies but does not charge the institutions for those inspections. Similarly, FDIC is authorized to charge for bank examinations but it does not do so. These findings led to the recommendation in figure 6.

Figure 6: Recommendation Regarding Charging for Bank Examinations

Reconsider its policy not to charge for bank examinations.

Source: GAO/GGD-96-128.

The Federal Reserve continues to believe that it should not charge for bank examinations. Federal Reserve officials told us that, since state member banks already pay state banking commissions for examinations, an additional charge for a Federal Reserve examination would increase the cost and lessen the value of a state banking charter, thus compromising the nation's dual banking system.[6] Banks pay an array of annual charges and assessments associated with their charters, as table 1 indicates.

[6]The actual cost of bank regulation includes the cost of complying with regulation as well as any direct charges. Compliance costs, however, are difficult or impossible to observe or measure, while any direct costs are reflected in a bank's accounting records. This measurement issue is discussed in G. Elliehausen, *The Cost of Bank Regulation: A Review of the Evidence*, Federal Reserve Board Staff Study, April 1998.

Table 1: Charges and Assessments on Banks, by Charter, as of September 2002

Bank charter	Primary federal supervisor	Annual fees and assessments (federal/state)	Federal Reserve Bank capital	Federal deposit insurance premiums
State-chartered member of the Federal Reserve System	Federal Reserve	Federal: No State: Yes—states charge a variety of fees and assessments	Yes	Yes
State-chartered nonmember banks	FDIC	Federal: No State: Yes—states charge a variety of fees and assessments	No	Yes
National banks	OCC	Federal: Yes State: No	Yes	Yes

Note: Since the Bank Insurance Fund balance exceeded the Designated Reserve Ratio (DRR) target, 1.25 percent of deposits, in 1995, FDIC is not currently charging insurance premiums except for banks that are considered to pose particular risk of imposing charges on the Bank Insurance Fund. The Federal Deposit Insurance Corporation Improvement Act of 1991 established the DRR target.

Source: GAO analysis of banking data.

All three federal bank regulators are self-funded. Differences in their funding mechanisms, however, may lead to differences in who ultimately pays the costs of supervision and regulation, even if the supervisory and regulatory actions serve the common purposes of ensuring that banks are operated in a safe and sound manner. The Federal Reserve funds its operations from the earnings on its portfolio of Treasury securities, as previously noted. Since the Federal Reserve's transfers to the Treasury are reduced by the expenses of its bank supervisory and regulatory activities, the taxpayer ultimately pays for Federal Reserve activities. FDIC may fund its operations from the premiums that banks pay for deposit insurance. However, since the Bank Insurance Fund is 1.25 percent of bank deposits, which it has been since 1995, FDIC generally does not charge banks premiums for deposit insurance. If FDIC were to begin charging insurance premiums, then either the bank's owners or customers, including depositors, would be paying for FDIC examinations. OCC is funded by assessments on the assets held by national banks and fees for services. Under this arrangement, the owners or customers of national banks pay for OCC operations. The differences among the funding approaches of the federal bank regulators continue to raise questions about whether these impose unequal burdens on banks—varying with their charter—and their customers.

Bank decisions to select (or maintain) one charter over the alternatives depend on the relative advantages of the charters as well as the associated costs. Federal Reserve officials argue that the dual banking system has worked well historically, allowing banks to choose the charter that best serves their business plan and, thus, has promoted innovation and a wider array of services for bank customers. In a 1997 speech, Federal Reserve Chairman Alan Greenspan commented:

> "The dual banking system not only fosters and preserves innovation but also constitutes our main protection against overly zealous and rigid federal regulation and supervision. A bank must have a choice of more than one federal regulator, and must be permitted to change charters, to protect itself against arbitrary and capricious regulatory behavior. Naturally, some observers are concerned that two or more federal agencies will engage in a 'competition in laxity,' and we must guard against that; but the greater danger, I believe, is that a single federal regulator would become rigid and insensitive to the needs of the marketplace."[7]

Further, Federal Reserve officials note that the roughly even shares of banks across the charters, and consistent shares of deposits among the charters, suggest that the relative costs and benefits of the charters balance. National banks, they believe, see a value in their charter that at least offsets any additional costs.

OCC, however, has argued that the current fee structure may distort the dual banking system:

> "Healthy competition in the quality of supervision and innovation in meeting the needs of banks and their customers should lie at the heart of our dual banking system. Unfortunately, today a primary focus of this competition is on price. Because state banks receive a federal subsidy for the predominant part of their supervision, there is a cost incentive for banks to avoid or depart from the national charter in favor of the heavily subsidized state charter. This inevitably tends to undermine a vigorous and healthy dual banking system."[8]

OCC has proposed that the costs of supervising national banks (which OCC performs) and state supervision of state-chartered banks be paid from FDIC insurance funds. This approach would attempt to provide

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[7]Remarks by Chairman Alan Greenspan, Federal Reserve Board, at the Annual Convention of the Independent Bankers Association of America, Phoenix, Arizona, March 22, 1997.

[8]*OCC Quarterly Journal*, vol. 20, no. 4, December 2001, p. 32.

consistency at the federal regulator-level by having the costs of regulation borne by taxpayers or depositors. We have generally favored an approach in which regulated entities pay for their own federal regulation.

Since the Federal Reserve continues to strongly disagree with our recommendation regarding charging for bank examinations, actions to implement the recommendation are unlikely. While we continue to believe that a strong argument exists for industry funding of federal supervision and regulation, we also recognize the benefits of the dual banking system. Ultimately, however, it is up to Congress to decide how to fund federal regulation and to balance the differences among the different bank regulators.

Scope and Methodology

To review the Federal Reserve's actions in response to our recommendations, we interviewed staff from the Federal Reserve Board's Division of Reserve Bank Operations, Division of Banking Supervision and Regulation, Office of Inspector General, as well as the Board's Staff Director for Management. We reviewed relevant policies and other Board actions and documents. We did not visit any Reserve Banks to verify or review implementation of these new policies.

We conducted our work in Washington, D.C., between April and August, 2002, in accordance with generally accepted government auditing standards.

Agency Comments

We requested comments on a draft of this report from the Board. In these comments, the Director of the Division of Reserve Bank Operations and Payment Systems agreed with the information presented in this report; the comments are reprinted in appendix I. We incorporated the Board's technical comments where appropriate.

As agreed with your offices, unless you publicly release its contents earlier, we plan no further distribution of this report until 30 days from its date. At that time, we will send copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Banking, Housing, and Urban Affairs, and the House Committee on Financial Services. We will also send copies to the Chairman of the Board of Governors of the Federal Reserve System, and we will make copies available to others on request. In addition, this report is available at no charge on our Web site at http://www.gao.gov.

Please contact me or James McDermott, Assistant Director, at (202) 512-8678 if you or your staff have any questions concerning this report. Other key contributors to this report were Thomas Conahan and Josie Sigl.

Thomas J. McCool
Managing Director, Financial Institutions and
Community Investment

Comments from the Federal Reserve System

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

LOUISE L. ROSEMAN
DIRECTOR
DIVISION OF
RESERVE BANK OPERATIONS
AND PAYMENT SYSTEMS

September 9, 2002

Mr. Thomas J. McCool
Managing Director, Financial Markets
and Community Investment
United States General Accounting Office
Washington, D.C.

Dear Mr. McCool:

Thank you for the opportunity to comment on the GAO's draft report *Federal Reserve System: Update on GAO's 1996 Recommendations.* As your draft report reflects, the Federal Reserve has taken a number of steps in recent years to improve the quality and cost-effectiveness of its operations; many of these initiatives have also further enhanced the reliability and resilience of our critical functions. We will continue to pursue opportunities to increase operational efficiency, which should help ensure that the Federal Reserve uses taxpayer funds prudently and provides payment services to depository institutions at reasonable fees.

We have provided technical comments to the draft report under separate cover.

Sincerely,

Louise L. Roseman

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