Federal Reserve System

The Federal Reserve System (FR System) was created by Congress under the Federal Reserve Act of 1913. The FR System consists of the Federal Reserve Board of Governors (Board), the Federal Open Market Committee (FOMC), and the FRBs. Collectively, the FR System serves as the nation's central bank and is responsible for formulating and conducting monetary policy, issuing and distributing currency (Federal Reserve Notes), supervising and regulating financial institutions, providing nationwide payments systems (including large-dollar transfers of funds, automated clearinghouse (ACH) operations, and check collection), providing certain financial services to federal agencies and fiscal principals, and serving as the U.S. Government's bank. Monetary policy includes actions undertaken by the FR System that influence the availability and cost of money and credit as a means of helping to promote national economic goals. The FR System also conducts operations in foreign markets in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC to carry out its central bank responsibilities. The FR System is not included in the federal budget. It is considered an independent central bank, and its decisions are not ratified by the executive branch of the U.S. Government.

The Department interacts with the FRBs in a variety of ways, including the following:

- The FRBs serve as the Department's fiscal agent and depositary, executing banking and other financial transactions on the Department's behalf. The Department reimburses the FRBs for these services, the cost of which is included on the Consolidated Statements of Net Costs
- The FRBs hold Treasury and other federal securities in the FRBs' System Open Market Account (SOMA) for the purpose of conducting monetary policy (Note 16)
- The FRBs hold gold certificates issued by the Department in which the certificates are collateralized by gold (Note 6)
- The FRBs hold SDR certificates issued by the Department which are collateralized by SDRs (Notes 5 and 12)
- The FRBs are required by Board policy to transfer their excess earnings to the Department on behalf of the U.S. Government (Notes 13 and 23)

The Department also consults with the FR System on matters affecting the economy and certain financial stability activities (Notes 7, 11 and 26). The above financial activities involving the Department are accounted for and disclosed in the Department's consolidated financial statements. In accordance with SFFAC No. 2, *Entity and Display,* the FR Systems' assets, liabilities, and operations are not consolidated into the Department's financial statements.

Federal Reserve System Structure

The Board is an independent organization governed by seven members who are appointed by the President and confirmed by the Senate. The full term of a Board member is 14 years, and the appointments are staggered so that one term expires on January 31 of each even-numbered year. The Board has a number of supervisory and regulatory responsibilities for institutions including, among others, state-chartered banks that are members of the FR System, bank holding companies, and savings and loan holding companies. In addition, the Board has general supervisory responsibilities for the 12 FRBs, and issues currency (Federal Reserve Notes) to the FRBs for distribution.

The FOMC is comprised of the seven Board members and five of the 12 FRB presidents, and is charged with formulating and conducting monetary policy primarily through open market operations (the purchase and sale of certain securities in the open market), the principal tool of national monetary policy. These operations affect the amount of reserve balances available to depository institutions, thereby influencing overall monetary and credit conditions. The 12 FRBs are chartered under the Federal Reserve Act, which requires each member bank to own the capital stock of its FRB. Supervision and control of each FRB is exercised by a board of directors, of which three are appointed by the Board of Governors of the FR System, and six are elected by their member banks.

The FRBs participate in formulating and conducting monetary policy, distribute currency and coin, and serve as fiscal agents for the Department, other federal agencies and fiscal principals. Additionally, the FRBs provide short-term loans to depository institutions and loans to participants in programs or facilities with broad-based eligibility in unusual and crucial circumstances when approved by the Board.

Federal Reserve System Assets and Liabilities

The FRBs hold Treasury and other securities in the SOMA for the purpose of conducting monetary policy. Treasury securities held by the FRBs totaled $1.6 trillion and $1.7 trillion at September 30, 2012 and 2011, respectively (Note 16). These assets are generally subject to the same market (principally interest-rate) and credit risks as other financial instruments. In the open market, the FR System purchases and sells Treasury securities as a mechanism for controlling the money supply.

The FRBs have deposit liabilities with Treasury and depository institutions. The FRBs issue Federal Reserve Notes, the circulating currency of the United States, which are collateralized by the Treasury securities and other assets held by the FRBs.

Financial and other information concerning the FR System, including financial statements for the Board and the FRBs, may be obtained at http://www.federalreserve.gov.

FRB Residual Earnings Transferred to the Department

FRBs generate income, from interest earned on securities, reimbursable services provided to federal agencies, and the provision of priced services to depository institutions as specified by the Monetary Control Act of 1980. Although the FRBs generate earnings from carrying out open market operations (via the earnings on securities held in the SOMA account), their execution of these operations is for the purpose of accomplishing monetary policy rather than generating earnings. Each FRB is required by Board policy to transfer to the Department its residual (or excess) earnings, after providing for the cost of operations, payment of dividends, and reservation of an amount necessary to equate surplus with paid-in capital. These residual earnings may vary due to, among other things, changes in the SOMA balance levels that may occur in conducting monetary policy. In the event of losses, or a substantial increase in capital, an FRB will suspend its payments to the U.S. Treasury until such losses or increases in capital are recovered through subsequent earnings. The FRB residual earnings of $82.0 billion and $82.5 billion for fiscal years ended September 30, 2012 and 2011, respectively, are reported as custodial revenues on the Department's Statements of Custodial Activity. They constituted three percent of the Department's total custodial revenues collected in fiscal years 2012 and 2011. "Taxes, Interest and Other Receivables, Net" includes a receivable for FRB's residual earnings which represents the earnings due to the U.S. Treasury as of September 30, but not collected by the U.S. Treasury until after the end of the month (Note 13).

2. FUND BALANCE

As of September 30, 2012 and 2011, fund balance consisted of the following (in millions):

	2012	2011
Appropriated Funds	**$ 315,690**	$ 344,913
Revolving Funds	**26,698**	35,464
Special Funds	**976**	721
Clearing Funds	**681**	392
Deposit Funds	**163**	170
Other Funds (principally Receipt, Trust, and Suspense Funds)	**138**	124
Total Fund Balance	**$ 344,346**	$ 381,784

Appropriated funds consist of amounts appropriated annually by Congress to fund the operations of the Department.