The Effectiveness of Federal Reserve Bank Governance

Renée Adams
University of Queensland

Motivation

- For another project, collected data on bank directors
  - They sometimes sit on Federal Reserve Bank boards
  - → Is this a good idea?
  - → More generally, is the governance of the Federal Reserve banks effective?
    - Debated at least since 1970s
    - With recent consolidation in banking industry, influence of individual banks is growing
- Challenge to examine governance of non-profits
  - → Exploratory

Basic Facts about Reserve Bank Boards

- 12 Federal Reserve banks (FRBs)
- Each is separately incorporated not-for-profit
  - Supervised by board of directors
- Board structure determined by Federal Reserve Act
  - 9 directors at each FRB
    - 3 class C directors appointed by Board of Governors
    - 6 directors nominated and elected by member banks in district
      - 3 class B directors represent the public
      - 3 class A directors represent the member banks
- Directors serve staggered terms of 3 years each
  - Generally at most two terms
- For purposes of election, banks grouped by capital into 3 groups: small, medium and large
  - Each group elects one class A and one class B on a rotating basis
  - Each member bank can nominate a candidate and has 1 vote
  - Only 1 subsidiary of a bank holding company can vote

Responsibilities of FRB directors

- Overseeing management of Reserve Banks
  - Appoint the Reserve Bank President and Vice-President and determine their salaries (subject to the Board's approval) and appoint all officers of the Bank
  - They review the Reserve Bank's budget and are responsible for internal audits
- Participating in the formulation of monetary and credit policies
  - Responsible for setting the discount rate (also subject to Board approval)
  - They advise Reserve Bank Presidents on regional business conditions prior to each FOMC meeting
- Acting as a link between government and private sector

To whom are they accountable?

- FRBs are privately owned by member banks in its district
  - But, FRBs are not responsible only to banks
  - Federal Reserve Act requires that boards administer affairs of bank “fairly and impartially and without discrimination in favor of or against any member bank or banks”
- FRBs operate solely in the public interest

  → Division of directors into classes
    - Class B and C directors should represent the public “with due but not exclusive consideration to the interests of agriculture, commerce, industry, services, labor, and consumers.”

  → Policy of rotation

Do directors appear to represent all stakeholders fairly?

- Whom do they represent?
  - Which banks are represented on FRB boards?
- How often do they rotate?
- Do their employers appear to gain differentially from their service on FRB board?
  - Event study around appointment
    - Is service costly to employer or beneficial?
    - If it is beneficial, does it differ between classes?

Preview of Results

- While class A directors need only represent the financial community, they are ALL employed by banking firms
- Officers of large banking firms with fewer nonperforming loans are more likely to serve as class A directors
- Class A directors have lower tenure than class B or C directors
- The stock price reaction to the appointment to the board of a FRB is positive
  - It is more positive for class A directors

Potential Interpretation

- Large banks may be disproportionately represented on FRB boards
  - However, this may also reflect the quality of directors
- Although service on boards of FRBs involves a substantial time commitment, employers seem to benefit from the service
- Employers of class A directors benefit more → suggests that appointment may not merely be a reputational signal

→ Results cast some doubt on idea that boards represent all stakeholders equally

Data

- Data on boards of FRBs from 1990-2001 from Federal Reserve Bulletins
- 370 directors
  - 141 class A directors, 120 class B directors and 109 class C directors
  - 66 class A directors employed either directly or by the subsidiary of a publicly traded banking firm, 32 class B and 38 class C directors employed by publicly traded non-banking firms
- Election dates
  - Requested circulars from Federal Reserve Banks
  - Freedom of Information Act
    - Limited coverage for some FRBs: Chicago, Boston, Kansas,…
  - Press releases from BOG, articles from Wall Street Journal, American Banker

Financial Data

- Stock price data for all publicly traded firms is from CRSP
- For banks and bank holding companies, accounting data is from the Call and Y9-C reports for the closest year-end prior to the election of one of its officers to a term as a class A director
- For each class A appointment, I augment the data with accounting data from the Call and Y9-C reports on the same date for an "industry" data set of other banks in the same district
  - All bank holding companies and banks not held by bank holding companies in that district

Table 3: Univariate Comparison at the Time of Election of Characteristics of Banking Firms Represented on FRB Boards to All Other Banking Firms

Panel A			
Variable	**Mean for Banking Firms on Fed Board (173 Observations)**	**Mean for Other Banking Firms (164469 Observations)**	**Difference**
Assets (millions)	1.93e+07	511259.2	1.88e+07***
Employees	6525.48	190.8865	6334.593***
Non Performing Loans/Loans	0.0150134	0.0190868	-0.0040734**
ROA	0.010286	0.0074249	0.0028611
ROE	0.1217087	0.0331017	0.088607

Table 5b: Parent Holding Company Characteristics Related to Class A Directorships -Probit

	Dependent Variable: Dummy if Officer of Parent Holding Company Elected Class A Director		
	I	II	III
Assets (millions)	-1.18e-08***	4.68e-09***	4.25e-09***
	[3.16]	[6.54]	[4.23]
Employees	0.00006***		
	[5.40]		
Fraction Non Performing Loans	-4.58658***	-3.53219***	-3.12601**
	[3.11]	[2.81]	[2.04]
ROA	0.63250***	0.64492***	0.59279***
	[3.08]	[3.05]	[2.75]
Number of Entities in District			-0.00053***
			[5.28]
Mean ROA in District			-575.99904*
			[1.65]
Mean Assets in District			-1.24e-08
			[1.07]
Constant	-3.12045***	-3.11261***	-2.62844***
	[97.07]	[99.94]	[27.00]
Observations	158639	158639	158633
Clustering of Standard Errors	None	None	District

Table 7: Event Study of Appointments to Federal Reserve Bank Boards

Variable	*Mean*	*Positive:Negative*	*Patell Z*
Event date=Election or Announcement Date (109 Observations)			
AR (0)	0.61%	59:50*	2.483***
CAR (-30,-2)	0.68%	54:55	1.899**
CAR (-1,0)	0.62%	61:48**	2.022**
CAR (+1,+30)	0.56%	50:49	-0.165
Event date=Nomination Date (54 Observations)			
AR (0)	0.61%	28:26	3.172***
CAR (-30,-2)	-1.91%	26:28	-0.700
CAR (-1,0)	0.93%	27:27	3.208***
CAR (+1,+30)	2.10%	29:25	1.539*

Table 8c: Cross-sectional Regression Analysis of CARs (-1, 0) on Election Date-the Reaction to Class A Appointments

	Dependent Variable: CAR (-1, 0) on Election Date			
	I	II	III	IV
Class A	0.01878**	0.01804**	0.01864*	0.0166
	[2.57]	[2.26]	[1.78]	[1.62]
First Term Dummy	0.01118*	0.01377*		0.00821
	[1.69]	[1.80]		[1.02]
Previous Branch Director Dummy		-0.00728		
		[0.76]		
Constant	-0.01898***	-0.01774**	-0.01091	-0.01239
	[2.68]	[2.17]	[0.79]	[0.92]
Observations	52	46	52	52
R-squared	0.089	0.105	0.233	0.24
Fixed effects	None	None	District	District

Conclusion

- Federal Reserve Act requires that boards administer affairs of bank “fairly and impartially and without discrimination in favor of or against any member bank or banks”
  - It appears as if large, well-performing banks more likely to be represented
  - It appears as if it is better to be a banker on the board than a non-banker
- It may be better to have more qualified bankers on the board
- It may be unrealistic to expect that class A employers should not gain more from service than class B and C directors

- But, not clear if results are consistent with the goals of the Federal Reserve Act