United States General Accounting Office

GAO

Report to Congressional Requesters

September 2002

FEDERAL RESERVE SYSTEM

The Surplus Account

GAO
Accountability * Integrity * Reliability

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Contents

Abbreviations

CBO	Congressional Budget Office
ECB	European Central Bank
FRBM	Federal Reserve Bank of Minneapolis
OMB	Office of Management and Budget

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

September 18, 2002

The Honorable Byron Dorgan
The Honorable Harry Reid
United States Senate

Our 1996 report to you[1] recommended that the Board of Governors of the Federal Reserve System (Federal Reserve Board) review its policies regarding the size of the Federal Reserve Banks' combined capital surplus account and determine if opportunities exist to decrease the amount held in the account. The consolidated capital surplus account is the aggregate of separate surplus accounts held at each of the 12 Reserve Banks, and the account represents cumulative retained net earnings for the Reserve Banks—that is, cumulative net earnings not paid to the Department of the Treasury (Treasury). According to Board publications, the purpose of the surplus account, a capital account, is to ensure that adequate capital is available to absorb possible losses, such as losses in its foreign currency holdings when the dollar appreciates against foreign currencies. Since our 1996 report, the surplus account has grown from $4.5 billion to $7.3 billion as of December 31, 2001.

The Federal Reserve System includes the Board of Governors, a federal agency, and 12 district banks (Reserve Banks) that are federally chartered corporations. The Reserve Banks fund their operations primarily through earnings on the Reserve Banks' portfolios of Treasury securities. The bulk of Reserve Banks assets are in outright holdings of Treasury securities. As of December 31, 2001, these assets accounted for about 84 percent of Reserve Banks' assets.

The Reserve Banks use earnings to pay operational expenses and dividends to member banks and to fund their capital surplus accounts. By practice, the Reserve Banks transfer excess net earnings averaging about $500 million to the Treasury weekly, usually every Wednesday. In 2001, these transfers amounted to more than $27 billion. However, the amount and timing of the Reserve Banks' payments to the Treasury are not regulated by law. The Federal Reserve Board has discretion over the amounts the Federal Reserve System transfers to the Treasury.

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

Each of the 12 Reserve Banks maintains two capital accounts—a paid-in capital account and a surplus account. The paid-in capital account represents the contributions by member banks of the Federal Reserve System. Under the Federal Reserve Act, members of the Federal Reserve System, which include state-chartered banks that apply for and have been granted membership and all national banks, must subscribe to the stock of their respective Reserve Bank. The subscription is 6 percent of each member bank's capital and surplus. Half of the subscription amount is paid by the member banks to the Reserve Banks—and is reflected in the Reserve Banks' paid-in capital—and half is on call by the Federal Reserve Board.[2] The Reserve Banks' paid-in capital changes frequently because member banks' capital changes. Dividends paid by the Reserve Banks to the member banks are set by law at the rate of 6 percent on paid-in capital stock.

The Reserve Banks' second capital account is the capital surplus account. According to Federal Reserve Board policy, this account is to be maintained at a level equal to the paid-in capital. The capital surplus account is funded from the Reserve Banks' earnings after operating expenses and dividends are paid. In 2001, the value of the capital surplus account was just over 1 percent of the total assets of the 12 Reserve Banks. The capital surplus account is adjusted annually so that the target level is equal to the amount in the paid-in capital account at the time of the adjustment.

As agreed with your offices, the objectives of this report are to describe (1) the Federal Reserve Board's rationale for maintaining the capital surplus account, (2) policies and practices of selected foreign central banks regarding accounts that serve similar functions, (3) the frequency and level of use by the Federal Reserve Banks of their surplus accounts from 1989 to 2001, and (4) the potential effects of reducing the capital surplus account on the federal budget and the economy.

To address these objectives, we interviewed officials from the Federal Reserve Board, the Treasury, and the Office of Management and Budget (OMB); we also spoke with officials from the Congressional Budget Office (CBO). We obtained information on the Bank of Canada, the Bank of England, the Bundesbank (Germany's central bank), and the European

[2]Ownership of Reserve Bank stock does not carry the usual rights of control and financial interest ordinarily associated with being a shareholder in a private-sector corporation.

Central Bank (ECB). We also analyzed Board data on the weekly losses that the 12 Reserve Banks incurred from 1989 through 2001 to determine the extent to which the Reserve Banks needed to draw down their capital surplus accounts. Our scope and methodology is discussed in more detail in appendix I. We conducted our work in Washington, D.C., between April 2002 and August 2002 in accordance with generally accepted government auditing standards.

Results in Brief

The Reserve Banks use their capital surplus accounts to act as a cushion to absorb losses. *The Financial Accounting Manual for Federal Reserve Banks* says that the primary purpose of the surplus account is to provide capital to supplement paid-in capital for use in the event of loss. Federal Reserve Board officials noted that the capital surplus account absorbs losses that a Reserve Bank may experience, for example, when its foreign currency holdings are revalued downward. Federal Reserve Board officials noted, however, that it could be argued that any central bank, including the Federal Reserve System, may not need to hold capital to absorb losses, mainly because a central bank can create additional domestic currency to meet any obligation denominated in that currency. On the other hand, it can also be argued that maintaining capital, including the surplus account, provides an assurance of a central bank's strength and stability to investors and holders of its currency, including those abroad. The growth in the Reserve Banks' capital surplus accounts can be attributed to growth in the size of the banking system together with the Federal Reserve Board's policy of equating the amount in the surplus account with the amount in the paid-in capital account. The level of the Federal Reserve capital surplus account is not based on any quantitative assessment of potential financial risk associated with the Federal Reserve System's assets or liabilities. According to Federal Reserve officials, the current policy of setting levels of surplus through a formula reduces the potential for any misperception that the surplus is manipulated to serve some ulterior purpose. In response to our 1996 recommendation that the Federal Reserve Board review its policies regarding the capital surplus account, it conducted an internal study that did not lead to major changes in policy.

Selected major foreign central banks maintain accounts with functions similar to the Federal Reserve System's capital surplus account. Although their accounts are not fully comparable with the Federal Reserve System capital surplus account, the Bank of England, the Bundesbank, and the ECB have capital surplus or reserve accounts in addition to their paid-in capital accounts that are used as cushions against loss. The Bank of

Canada does not require an account to buffer the impact of foreign currency movements because it does not hold a significant amount of foreign currency on its balance sheet. According to central bank officials, the levels of these accounts were set by law for the Bundesbank and the ECB. In the United Kingdom, the level is negotiated between the Bank of England and Her Majesty's Treasury (Treasury of the United Kingdom). The Bundesbank and the ECB have created additional accounts to cushion against financial risk.

The Federal Reserve System calculates earnings and transfers excess earnings to the Treasury on a weekly basis. Although the Federal Reserve System has not had an annual operating loss since 1915, the Reserve Banks recorded some weekly losses between 1989 through 2001, thus temporarily reducing their capital surplus accounts to cover these weekly losses.[3] Individual Reserve Banks relied on their capital surplus accounts at least 158 times during 1989 to 2001 to absorb weekly losses, primarily from foreign revaluation losses, but the frequency of transferring surplus funds to absorb losses declined during this time frame.[4] Although numerous factors can influence a Reserve Bank's net earnings, in most cases, according to Federal Reserve Board officials, these losses can be attributed to increases in the U.S. dollar's foreign currency value, leading to lower values for the Reserve Banks' holdings of foreign currency. Until 2001, the Federal Reserve System recognized foreign currency revaluations at month's end, a process that at times led to large downward revaluations of foreign currency assets that would exceed the Reserve Banks' earnings for that week, resulting in a weekly loss. The capital surplus accounts were generally replenished from subsequent earnings. According to Federal Reserve Board officials, the Federal Reserve System now revalues its foreign currency holdings on a daily basis rather than a monthly basis. They

[3]A weekly loss is defined as a week in which the Reserve Bank expenses and losses are greater than the revenues and gains. The Federal Reserve Board data we analyzed did not include the weeks in which the revenues and gains for a week were greater than the expenses and any losses.

[4]These 158 weekly losses were out of 7,337 possible occurrences during the approximately 13 years of weekly data for the 11 Reserve Banks included in this analysis. The analysis and number of weekly losses do not include the Federal Reserve Bank of Minneapolis because it would skew the overall total. The Federal Reserve Bank of Minneapolis, which will be discussed in greater detail later in the report, had a lower level of earnings relative to its capital than the other Reserve Banks. The Federal Reserve Bank of Minneapolis's lower earnings were the result of its lower level of Treasury securities in comparison to its other assets and capital than other Reserve Banks, which primarily reflected its purchase and storage of currency issued by the other Reserve Banks.

note that daily revaluations, which began in July 2001, generally lead to smaller revaluation losses than do monthly revaluations.

Reducing the Federal Reserve System capital surplus account would create a one-time increase in federal receipts, but the transfer by itself would have no significant long-term effect on the budget or the economy. Amounts transferred to the Treasury from reducing the capital surplus account would be treated as a receipt under federal budget accounting but do not produce new resources for the federal government as a whole. Absent offsetting policy changes, the one-time transfer would reduce the federal budget deficit or increase the budget surplus at the time of the transfer, and federal debt held by the public likewise would decrease by the amount transferred. In turn, federal interest outlays on debt held by the public would be lower in subsequent periods. However, Reserve Banks' earnings payments to the Treasury also would be lower in subsequent periods because the Federal Reserve would hold a smaller portfolio after the transfer. Over time, lower receipts from Federal Reserve earnings would approximately offset the lower interest payments to the public.

Background

As previously noted, the capital surplus account is adjusted to a level equal to the paid-in capital account. This adjustment, however, is made at the end of the calendar year. During the year, another capital account, undistributed net income, reflects the amount of net earnings for the current year that have not been distributed. Each week, the sum of the balance in the capital surplus account and undistributed net income is compared with the paid-in capital account. If the amount of the capital surplus account and undistributed net income combined is greater than capital paid-in, the excess is paid to the Treasury a week later.[5] This payment in turn reduces the undistributed net income account. At the end of the calendar year, the balance in the undistributed net income is transferred to the capital surplus account up to the amount of paid-in capital. Any remaining balance is distributed to the Treasury.

Essentially, the capital surplus account represents earnings retained from prior years, and the undistributed net income represents earnings retained from the current year. Both the capital surplus account and the

[5]If significant losses over the following week would cause this planned payment to Treasury to exceed the undistributed net income, the payment amount would be lowered to avoid reducing the capital surplus account.

undistributed net income account provide a cushion against losses. Any Reserve Bank losses first reduce the undistributed net income account. The capital surplus account is then reduced if the undistributed net income account is not sufficient to absorb the loss.

Transfers of the Reserve Banks' net earnings to the Treasury are classified as federal receipts. Federal receipts consist mostly of individual and corporate income taxes and social insurance taxes but also include excise taxes, compulsory user charges, customs duties, court fines, certain license fees, and the Federal Reserve System's deposit of earnings.

The Treasury securities held by Reserve Banks are considered part of the federal debt held by the public. Federal debt consists of securities issued by the Treasury and a relatively small amount issued by a limited number of federal agencies. Federal debt is categorized into debt held by the public and debt held by government accounts. Debt held by the public is that part of the gross federal debt held outside of federal budget accounts, and this includes any federal debt held by individuals, corporations, state or local governments, the Federal Reserve System, and foreign governments and central banks.

The Consolidated Appropriations Act of 2000[6] directed the Reserve Banks to transfer to the Treasury additional surplus funds of $3.752 billion during fiscal year 2000. The Federal Reserve System transferred the funds on May 10, 2000. Under the act, the Reserve Banks were not permitted to replenish their accounts during fiscal year 2000. Once the Reserve Banks were legally permitted to replenish the accounts, they did. By December 31, 2000, the capital surplus account was replenished for 11 of the 12 Reserve Banks.

[6]Pub. L. No. 106-113, 13 Stat. 1501A-304 (1999) 12 U.S.C. § 289 (b) (2000).

The Federal Reserve System Maintains a Capital Surplus Account to Cushion Against Losses

The Federal Reserve System maintains a capital surplus account to provide additional capital to cushion against potential losses. However, Federal Reserve Board officials have noted that it can be argued that a central bank, including the Federal Reserve System, may not need to hold capital to absorb losses, mainly because a central bank can create additional domestic currency to meet any obligation denominated in that currency. Federal Reserve Board officials acknowledged that determining the appropriate level of a central bank's capital account is difficult. The Federal Reserve Board's policy of maintaining the capital surplus account at the same level as that of the paid-in capital account has resulted in the capital surplus account growing from $4.5 billion in 1996 to $7.3 billion in 2001.[7]

The Federal Reserve System maintains the capital surplus account primarily as a cushion against losses. The *Financial Accounting Manual for Federal Reserve Banks* states that the primary purpose of the Federal Reserve capital surplus account is to provide capital to supplement paid-in capital for use in the event of loss. According to Board officials, the capital surplus reduces the probability that total Reserve Bank capital would be wiped out by a loss as a result of dollar appreciation, sales of Treasury securities below par value, losses associated with discount window lending, or any other losses. Individual Reserve Banks use the capital surplus account when they experience losses greater than the amount in their undistributed net income account.

Federal Reserve Board officials also noted that it could be argued that maintaining capital, including the surplus account, provides an assurance of a central bank's strength and stability to investors and foreign holders of U.S. currency. Currently, a significant portion of U.S. currency is held abroad. According to one estimate published by the Federal Reserve Board, $279.5 billion in U.S. currency was held overseas as of the fourth quarter of 2001. The total amount of Federal Reserve notes outstanding was $611.8 billion as of December 31, 2001. Federal Reserve Board officials stated that the demand for U.S. currency conceivably could fall if a large loss wiped out the Federal Reserve's capital accounts, giving a misimpression that the Federal Reserve was insolvent.

[7]As of September 4, 2002, the paid-in capital account was $8.2 billion. At the end of the year, the surplus account will be adjusted to reflect the growth in the paid-in capital account.

Federal Reserve Board officials have acknowledged publicly the argument that a central bank may not need capital to absorb losses because a central bank can always meet its obligations in its own currency. We found no widely accepted, analytically based criteria to show whether a central bank needs capital as a cushion against losses or how the level of such an account should be determined. In May 3, 2000, congressional testimony, then Federal Reserve Board Governor Laurence H. Meyer stated the following:

> "In the abstract, a central bank with the nation's currency franchise does not need to hold capital. In the private sector, a firm's capital helps to protect creditors from credit losses. Creditors of central banks however are at no risk of a loss because the central bank can always create additional currency to meet any obligation denominated in that currency."[8]

Moreover, an official representing one of the four foreign central banks that we contacted agreed that the concept of solvency was essentially meaningless for a central bank in its role as a creator of currency, and that a massive loss could make a central bank technically insolvent, but that there would be no impairment of its ability to create and manage assets and issue currency. However, Federal Reserve Board officials told us that, because the maintenance of the capital surplus account is "costless" to the taxpayer and to the Treasury, the argument that a central bank does not need capital is not a rationale for reducing the surplus to any particular level, including zero. We will discuss the possible effects of a change in the surplus account on the federal budget and the economy later in this report.

Federal Reserve Board officials told us that determining the appropriate level for a central bank's capital account is difficult. The growth in the Federal Reserve System's capital surplus account can be attributed to growth in the banking system together with the Federal Reserve Board policy of equating the amount in the capital surplus account with paid-in capital. The Federal Reserve System surplus has grown along with the paid-in capital account which itself grew as a result of expansion of the banking industry capital during the late 1990s. In 1996, the capital of all member banks (state member banks and national banks) totaled almost $157 billion; by December 2001, it was $267 billion. Because the Federal Reserve Act requires members to subscribe to a stock subscription equaling 6 percent of their capital and surplus, half of which is to be paid in, the

[8]Testimony of Laurence H. Meyer, Board of Governors of the Federal Reserve System, Committee on Banking and Financial Services, U.S. House of Representatives, May 3, 2000, p. 7.

Reserve Banks' capital paid-in accounts have increased along with member bank capital and surplus. As a result of the Federal Reserve Board's policy, the Federal Reserve capital surplus account grew correspondingly. The level of the Federal Reserve capital surplus account is not based on any quantitative assessment of the potential financial risk associated with the Federal Reserve's assets or liabilities. According to a Federal Reserve Board official, the current policy of setting the levels of surplus through a formula reduces the potential for any misperception that the surplus is manipulated to serve some ulterior purpose. In response to our 1996 recommendation that the Federal Reserve Board review its policies regarding the surplus account, the Federal Reserve Board conducted an internal study that did not lead to major changes in policy.

Several Foreign Central Banks Maintain Accounts That Function Much Like the Federal Reserve Surplus Account

Three of the four central banks that we contacted had capital accounts that included ownership shares as well as "surplus" accounts with functions similar to the Federal Reserve System capital surplus account (see table 1). We found the levels of these accounts varied in size and, with the exception of the Bank of England, officials from the four central banks explained that the levels were established by law. The Bundesbank and the ECB had also established additional "provision" accounts that were not part of the subscribed capital[9] or surplus accounts, but that served as an additional cushion against losses. The provision accounts were set up primarily to offset the central banks' exposure to foreign exchange rate and interest rate risk and their levels are evaluated on an annual basis. In contrast to these central banks, the Bank of Canada does not require an additional account to buffer the impact of foreign exchange rate and interest rate movements on their assets because it does not hold a significant amount of assets denominated in currencies other than the Canadian dollar on its balance sheet. Similarly, its domestic assets holdings of Canadian government securities are diversified across maturities, approximately mirroring the issuance of Canadian government securities. It should be noted that accounts at the four central banks that we contacted are not fully comparable with the Federal Reserve System capital surplus account because of differences in accounting practices.

[9]Capital has broad meaning and may include other accounts.

Table 1: Summary of “Surplus” Accounts Held at the European Central Bank, the Bank of England, the Bank of Canada, and the Bundesbank

Central bank	Arrangement
The European Central Bank	The “general reserve fund” surplus account was set up in accordance with the ECB statute and is funded through retained net earnings each year within legally prescribed limits.
The Bank of England	The Bank of England’s surplus account is the portion of retained earnings that the Bank of England keeps every year after it transfers a predetermined amount to the Treasury. Her Majesty’s Treasury and the Bank of England negotiate a 5-year plan to determine the amount that is transferred each year to the Her Majesty’s Treasury. The Bank of England establishes its posttax profit (loss), pays over to the Exchequer the share agreed with the Treasury beforehand, and retains the remainder in its capital reserve.
The Bundesbank	Bundesbank officials told us that, in addition to the paid-in capital and the statutory reserves, a “provisions” account was created in accordance with Section 26 (2) of the Bundesbank Act for the “creation of liability items for general risks associated with domestic and foreign business.”
The Bank of Canada	Bank of Canada officials told us that they do not have a surplus account because foreign currency accounts for only about 1 percent of the Bank of Canada’s assets. As a fiscal agent for the Canadian government, the bank manages the government’s foreign currency reserves but does not keep a significant amount of foreign reserve holdings on its books.

Source: Central bank officials and documents.

The Bundesbank and the ECB use accounting methods that differ from the Federal Reserve’s to cushion against foreign currency risk and have set up “revaluation accounts” representing valuation reserves arising from unrealized gains on assets and liabilities, including foreign currency. The levels of these accounts vary automatically in accordance with regular market valuations of the assets held compared to their original cost.[10]

The Bundesbank, bearing especially the foreign exchange risk in mind, has established a “provisions” account. When determining how much to put into this account, the Bundesbank evaluates its exposure to foreign exchange risk and interest rate risk, to the extent of which these risks are not already covered by the “revaluation account.” In addition to the “provisions” account, the Bundesbank also has a “statutory reserves”

[10]In practice, these revaluation accounts show unrealized gains. If unrealized losses from the previous year exceed the unrealized gains registered in the revaluation account at the end of the financial year, they are then transferred over to the profit and loss account as an expense.

account that serves as an additional financial buffer against risk. This reserve account may be used only to offset falls in value and to cover other losses. It is derived from the net profit each year and has a maximum level established by legislation.

The levels of capital that the central banks maintain are not directly comparable with the Federal Reserve's capital (including the surplus account) for several reasons. First, as previously described, there are differences in the accounting systems among the central banks. The Bundesbank and the ECB, for instance, use accounts that are not part of capital to serve as a cushion against loss. Additionally, when determining the levels of the "provisions" account, the Bundesbank and the ECB evaluated their exposure to exchange rate and interest rate risk. The Bank of Canada and the Bank of England, in contrast, do not face significant foreign exchange rate exposure in their accounts.

Reserve Banks Occasionally Have Used Funds from Their Surplus Accounts to Absorb Losses

The Federal Reserve System has not had an annual operating loss since 1915. From 1989 to 2001, the Reserve Banks incurred some weekly losses in which their weekly earnings were not sufficient to absorb the losses. The individual Reserve Banks drew on their capital surplus accounts at least 158 times to absorb weekly losses during the years of 1989 to 2001.[11] The frequency of transferring surplus funds to absorb losses declined during the years from 1998 and 2001. Although numerous factors can influence a Reserve Bank's net earnings, it appears that most of the weekly losses incurred by the Reserve Banks can be attributed to foreign currency revaluation. Federal Reserve Board officials noted that since the Reserve Banks began revaluing the Federal Reserve System's foreign currency holdings on a daily basis rather than a monthly basis in July 2001, they expect the size of these revaluations will be reduced.

Reserve Bank Earnings Were Not Sufficient to Absorb All of the Reserve Bank Weekly Losses

The individual Reserve Banks transferred funds occasionally from their capital surplus accounts to absorb losses from 1989 through 2001. On the basis of Federal Reserve Board data, 11 of the 12 Reserve Banks reported a total of 352 weeks in which earnings were less than expenses and losses. (The 352 weeks were out of 7,337 possible occurrences during the

[11]The Federal Reserve Bank of Minneapolis, which is not included in the total because it would have skewed the overall total, is discussed later in this section.

approximately 13 years of data at the 11 Reserve Banks.) The individual Reserve Banks transferred from the capital surplus accounts cumulatively 158 times, when the weekly loss was greater than the amount in the undistributed net income account. For the other 194 weekly losses, the undistributed net income was sufficient to absorb the losses.

The amount and frequency of the weekly losses incurred and the use of the capital surplus accounts varied across Reserve Banks. The Reserve Banks did not incur losses at the same frequency or magnitude because their portfolios of Treasury securities and foreign currency were not proportional across Reserve Banks. The size of a Reserve Bank's Treasury securities portfolios is driven largely by the value of Federal Reserve notes issued by the Reserve Bank,[12] but the size of its foreign currency portfolio is determined by the prior years' capital and surplus account levels. Four of 11 Reserve Banks (Atlanta, Dallas, Kansas City, and Philadelphia) had to transfer funds from their surplus accounts to cover more than 50 percent of their weekly losses (see table 2). The remaining 7 Reserve Banks transferred capital surplus funds that ranged from 26 percent to 46 percent of their weekly losses.

[12]Federal Reserve notes outstanding are considered a liability of the Reserve Banks. The primary asset counterpart to the Federal Reserve liability for currency in circulation is the Treasury securities and federal agency securities that each Reserve Bank holds.

Table 2: Eleven Reserve Banks' Use of Surplus Account from 1989 to 2001

Reserve bank	Number of surplus transfers	Percentage of their weekly losses requiring surplus funds	Maximum single surplus withdrawal (millions)	Maximum single surplus withdrawal as a percentage of the total surplus
Boston	5	26.3%	$47.3	49%
New York	6	33.3	344.6	52
Philadelphia	21	61.8	107.0	93
Cleveland	11	34.4	75.3	60
Richmond	18	40.0	183.0	52
Atlanta	21	51.2	216.7	88
Chicago	13	46.4	201.2	67
St. Louis	7	36.8	43.9	69
Kansas City	17	50	66.0	45
Dallas	24	55.8	167.5	91
San Francisco	15	38.5	258.6	82
Total	**158**	**N/A**	**N/A**	**N/A**

Note: This table does not include the Federal Reserve Bank of Minneapolis.

Source: Federal Reserve Board.

The Federal Reserve Bank of Minneapolis (FRBM) is not included in the table because, as explained below, the structure of its assets and liabilities differed significantly from that of the other Reserve Banks over the period surrounding the century date change and its results would bias the overall results. If the FRBM's capital surplus transfers were included, the frequency would increase to 207 times. From May 2000 to December 2001, FRBM drew down its surplus account 24 times to absorb its weekly losses, compared with only 25 times for the entire previous 11-year period (from Apr. 5, 1989, through Mar. 1, 2000). FRBM's surplus has not been fully restored to a level at which its value equates with its paid-in capital, and it has not made a payment to the Treasury since the statutorily mandated surplus transfer by the Consolidated Appropriations Act of 2000 was completed in May 2000.

The Federal Reserve Board staff provided us with two reasons for this condition. First, FRBM's share of earnings was lower than that for the average Reserve Bank compared with its share of the $3.752 billion transfer in May 2000. According to a Federal Reserve Board official, FRBM's lower earnings resulted from its relatively small share of the System Open Market Account[13] compared with the other 11 Reserve Banks. For Year 2000 contingency purposes, FRBM stored a large amount of currency for the other Reserve Banks. FRBM was selected because its bank building had a large cash vault. To obtain currency to store for the other Reserve Banks, FRBM had to purchase higher level of currency from the other Reserve Banks. FRBM essentially purchased this currency by reducing its share of the System Open Market Account. Secondly, increases in FRBM's capital paid-in account due to mergers and acquisitions by its member banks increased the amount of capital surplus needed to match the value of its paid-in capital. Federal Reserve Board staff expect that FRBM will resume weekly payments to the Treasury in late 2002 or early 2003.

During the period from 1989 to 2001, none of the Reserve Banks, including FRBM, entirely depleted their surplus accounts. Thus, the paid-in capital accounts were never needed to cushion any of the weekly losses the Reserve Banks incurred. After 1997, the frequency of capital surplus transfers by the Reserve Banks was considerably lower. From 1998 to 2001, the Federal Reserve System, excluding FRBM, averaged almost 5 surplus transfers annually compared with the period from 1989 to 1997, when the Federal Reserve System averaged over 15 surplus transfers annually. In 2001, the individual Reserve Banks, excluding FRBM, withdrew from their capital surplus account a total of eight times for a cumulative total of $292.4 million, almost 4.1 percent of the Federal Reserve System's capital surplus account.

Revaluation of Foreign Currency Assets Appears to Be a Primary Reason for the Reserve Banks' Losses

It appears that most of the weekly losses, which drew on the capital surplus account, resulted from revaluation of foreign currency assets. Federal Reserve Board officials told us that, in reviewing the data for the losses, they could not recall or identify reasons other than foreign currency revaluation as the primary reason for the weekly losses. Although the Federal Reserve System's asset portfolio is predominantly Treasury

[13]The System Open Market Account includes the Federal Reserve System's portfolio of Treasury and certain other securities that it has accumulated through open market operations.

securities, it does include foreign currency holdings. As of December 31, 2001, the Federal Reserve's foreign currency holdings were equivalent to $7.3 billion of euros, $7.2 billion of yen, and $65.6 million of interest receivables. When the dollar appreciates against a foreign currency, the value of the foreign currency holdings declines in dollar terms, and the Reserve Banks may incur a loss. According to Federal Reserve officials, such losses are the primary reason that Reserve Banks have drawn on their capital surplus accounts. Federal Reserve Board data on the Reserve Banks' weekly losses that occurred since 1997 also suggested that the losses resulted from downward revaluation of foreign currency assets.

Although none of the Reserve Banks' capital surplus accounts were ever entirely depleted, all of the capital surplus accounts were significantly reduced by one particular foreign currency loss. During the week of April 3, 1991, every Reserve Bank, including FRBM, recognized a loss that drew down their capital surplus accounts, reducing the Federal Reserve System's capital surplus by $1.67 billion. This loss represented almost a 67 percent reduction in the Federal Reserve System's capital surplus account. As of December 31, 1991, the capital surplus account totaled $2.65 billion. For 10 of 12 Reserve Banks, the reductions in capital surplus that week were the largest incurred for the 12-year period.[14] The reductions that week ranged from 49 percent to 93 percent of the respective Reserve Banks' capital surpluses. The Reserve Banks of Dallas and Philadelphia needed to withdraw 91 percent and 93 percent of their capital surplus accounts, respectively, to absorb the size of the loss. According to a Federal Reserve Board official, the huge net weekly loss was caused by a sharp appreciation of the U.S. dollar near the conclusion of the Gulf War.

Weekly losses resulting from revaluation of foreign currency holdings may occur less frequently in the future because of a recent change in Federal Reserve System's procedures that resulted from the Federal Reserve Board study that was conducted following our 1996 report. The Reserve Banks now revalue their foreign currency holdings on a daily basis rather than a monthly basis, and Federal Reserve Board staff told us that they expect daily basis revaluations, which began in July 2001, will lessen the volatility of these revaluations. Under the previous arrangement, the earnings of the week during which the revaluation occurred had to absorb any revaluation loss that had built up during the month since the previous revaluation,

[14]The Reserve Bank of Richmond's largest single withdrawal from its surplus account was for the week of April 4, 2001.

often leading to losses during that week. Daily revaluations generally lead to smaller revaluation losses than revaluing on a monthly basis, according to Federal Reserve Board officials, making it less likely that they will exceed weekly earnings.

Reducing the Surplus Account Provides One-Time Increase in Federal Receipts but Yields No New Resources for the Federal Government

Reducing the Federal Reserve surplus account would create a one-time increase in federal government receipts, thereby reducing the budget deficit (or increasing the federal budget surplus) at the time of the transfer. Because the Federal Reserve System is not included in the federal budget, a Reserve Bank transfer to the Treasury is recorded as a receipt under current budget accounting.[15] This move would reduce future Reserve Banks' earnings and in turn reduce their transfers to the Treasury in subsequent periods. Since the one-time transfer from the Federal Reserve System also increases Treasury's cash balance over time, the Treasury would sell fewer securities to the public and thus pay less interest to the public. Over time, the lower interest payments to the public approximately offset the lower receipts from Federal Reserve earnings.

After the temporary capital surplus reduction in 2000, transfers of Reserve Bank net earnings to the Treasury were lower as the Reserve Banks replenished their capital surplus accounts. However, a permanent capital surplus reduction would also reduce future Reserve Bank earnings because the Reserve Banks would hold a smaller portfolio of securities. Since reducing the surplus does not produce new resources for the government, however, there would not be significant economic effects from its reduction.

While a Reserve Bank transfer to Treasury is recorded as a receipt to the government, such transfers do not produce new resources for the federal government as a whole. As the nation's central bank, the Federal Reserve System carries out government functions, conducting monetary policy and promoting the stability of the U.S. financial system. As the Federal Reserve System describes itself, "…it is 'independent within the government.' It is

[15]The 1967 President's Commission on Budget Concepts recommended that the Federal Reserve System not be included in the federal budget even though it is a government instrumentality and is clearly a federal government operation. This recommendation was made for two main reasons: inclusion of the Reserve Banks in the budget might jeopardize the flexibility and independence of the monetary authorities and projection of operations forward—as would be required if the banks were included in the budget—did not appear feasible.

not outside the government.” The Federal Reserve System’s holdings, including the capital surplus account, may enhance the ability of the Federal Reserve System to perform these and other government functions. Reducing the capital surplus account and transferring to the Treasury would not move resources from private purposes to government purposes. Thus, the transfer, by itself, would have no significant long-term economic effects. CBO similarly concluded

> “…the transfer of surplus funds from the Federal Reserve to the Treasury has no import for the fiscal status of the Federal government… Where the funds reside has no *economic* significance. Hence, any transfer of the Federal Reserve surplus fund to the Treasury would have no effect on national savings, economic growth, or income.”[16] [Emphasis in original.]

Permanently reducing the Federal Reserve System’s capital surplus account would yield a one-time increase in federal receipts, under budget accounting; the transfer would have no net budgetary effect in subsequent years. Both OMB and Treasury officials told us that reducing the capital surplus account would cause the Reserve Banks to sell some of their Treasury securities portfolio. This move would reduce Reserve Bank earnings and, in turn, reduce payments to the Treasury in subsequent periods. This reduction in future transfers to the Treasury would occur even if the Reserve Banks were not allowed to replenish their capital surplus accounts.

As a hypothetical example, suppose that the Federal Reserve System were to reduce permanently its surplus account by $1 billion, and, to simplify the example, that it did so by selling $1 billion in Treasury securities at the end of a fiscal year and transferring the proceeds to the Treasury. This one-time transfer would increase federal revenues by $1 billion and, assuming no changes in fiscal policy, reduce that year’s deficit by $1 billion. With a smaller portfolio, the Reserve Banks’ annual earnings on their Treasury securities would decline by about $43 million, on the basis of the August 2002 interest rate on newly issued 10-year notes. As a result, the Federal Reserve’s annual payments to the Treasury would also decline by about $43 million for each of the next 10 years. This $43 million, however, is approximately offset by a decrease in interest that Treasury must pay.

Receipt of the $1 billion permits Treasury to sell less debt to the public. Continuing the hypothetical example, if the Treasury were to use the $1

[16] Congressional Budget Office, Cost Estimate for H.R. 974, Small Business Interest Checking Act of 2001, April 3, 2001, p. 8.

billion to reduce its issuance of 10-year notes, its borrowing costs would decrease by $43 million. Treasury's continued outlays for interest on the $1 billion of securities that the Federal Reserve System sold would thus be approximately offset by the interest expense that Treasury no longer would incur in selling the new securities. OMB staff explained that it would be impossible to quantify the exact budgetary effect of permanently reducing the capital surplus account, since the securities that the Federal Reserve System would sell to reduce the surplus account would not necessarily have the same interest rate as those that Treasury would no longer sell, nor the same interest rate as Treasury receives on its operating accounts held at the Federal Reserve System.

In a provision of the Omnibus Budget Reconciliation Act of 1993,[17] Congress directed for fiscal years 1997 and 1998 that the amount in the surplus account of any Reserve Bank in excess of the amount equal to 3 percent of the total paid-in capital and surplus of its member banks should be transferred to the Treasury. Moreover, the act required that the surplus accounts be reduced an additional $106 million in fiscal year 1997 and $107 million in fiscal year 1998 and that the amounts be transferred to Treasury. These transfers were made on October 1, 1997, and 1998, respectively. Also, under the act, the Reserve Banks were not permitted to replenish the surplus for these amounts during fiscal years 1997 and 1998.[18] As of December 31, 1998, the capital surplus account and the paid-in capital account were equal. Although the act did not specifically state the purpose of those transfers, its effect was to reduce the federal government's deficit in those years.

The capital surplus transfer mandated by the Consolidated Appropriations Act of 2000 resulted in a one-time increase in reported federal receipts but was clearly offset by lower Reserve Bank net earnings payments to the Treasury in the subsequent fiscal year. One reason for this is that the 2000 surplus reduction was temporary: the act prohibited the Reserve Banks from replenishing their surplus funds by the amounts they transferred in

[17]Pub. L. 103-66, Title III, § 3002.107 Stat. 337 (1993).

[18]Section 3002(a) of the Omnibus Budget Reconciliation Act of 1993 amended the Federal Reserve Act to provide, in pertinent part, as follows: "(3) REPLENISHMENT OF SURPLUS FUND PROHIBITED.—No Federal reserve bank may replenish such bank's surplus fund by the amount of any transfer by such bank under paragraph (1) during fiscal years 1997 and 1998." Pub. L. No. 103-66 § 3002(a) (1993). The transfer amounts under paragraph (1) were $106 million in fiscal year 1997 and $107 million in fiscal year 1998.

that fiscal year but did not prohibit subsequent replenishment. As previously stated, the Consolidated Appropriations Act directed the Reserve Banks to transfer to the Treasury surplus funds of $3.752 billion during fiscal year 2000. Under the act, the Reserve Banks were not permitted to replenish the capital surplus amounts transferred during fiscal year 2000. Because the Federal Reserve Board has discretion over how much it transfers to the Treasury, the Reserve Banks began replenishing the accounts as soon as they were legally allowed to in October 2000. To replenish the capital surplus accounts, the Reserve Banks ceased payments of their net earnings to the Treasury until the capital surplus accounts were replenished. In November 2000, CBO reported that receipts from the Federal Reserve System were $1 billion lower in October 2000 than they had been in October 1999 because the Federal Reserve System had temporarily stopped its weekly payments to the Treasury. Moreover, CBO noted that the Reserve Banks were replenishing their capital surplus accounts from earnings that would otherwise be paid to the Treasury and were not likely to resume their weekly payments until December 2000 or possibly later. Federal Reserve Board data on the replenishment of the Reserve Bank surplus accounts indicated that the Reserve Banks of Boston, Chicago, Dallas, Kansas City, and Philadelphia did not transfer any earnings to Treasury for as long as 5 to 6 weeks.

Any reduction in the capital surplus account would not have a significant effect on Treasury's financial management, according to Treasury officials. First, the capital surplus account represents a small fraction of the total federal budget. The capital surplus account was $7.3 billion as of December 31, 2001, while total federal outlays during fiscal 2001 totaled $1,863.9 billion; thus the capital surplus account was less than 1/10 of 1 percent of outlays. These officials observed that the capital surplus account balance represented a small percentage of the total amount of Treasury securities outstanding in a year. As of June 30, 2002, the total amount of Treasury securities outstanding was $6,126.5 billion. Finally, these officials noted that while the surplus account would be significant relative to Treasury's cash balances, these balances vary considerably on a monthly basis. While Treasury monthly cash balances averaged about $24 billion in fiscal 2001, for instance, average monthly balances ranged from $12.1 billion to $43.2 billion.[19]

[19]Treasury's operating cash is maintained in an account at the Federal Reserve Bank of New York as well as in tax and loan accounts in other financial institutions.

Conclusions

The Federal Reserve System maintains the surplus account to absorb losses. Since 1989, most of the weekly losses that resulted in using the capital surplus account were apparently due to monthly revaluation of the Federal Reserve System's holdings of foreign currencies. In most cases, the capital surplus account was replenished soon after absorbing the loss, and no Reserve Bank ever completely depleted its capital surplus account.

Since 2001, however, the Federal Reserve System has begun recognizing gains or losses on its foreign currency holdings on a daily basis rather than a monthly basis. This change should lessen the use of the capital surplus account. The surplus account has grown substantially since 1996, reflecting the growth in the member banks' capital and therefore their paid-in capital, which the Federal Reserve System uses as the basis for determining the targeted value of the surplus account.

Reducing the surplus account, however, would provide only a one-time increase in measured federal government receipts, reflecting a transfer from Reserve Banks to the Treasury. There would not be a significant economic effect from reducing the surplus account.

Agency Comments and Our Evaluation

We requested comments on a draft of this report from the Federal Reserve Board, OMB, and the Treasury. The Federal Reserve Board's comments are reprinted in appendix II. The Federal Reserve Board said that it generally agreed with the information in and conclusions of the report. The Federal Reserve Board also noted that it had separately provided technical corrections; we have incorporated these corrections where appropriate. OMB and the Treasury declined comment, although their staffs provided technical corrections that we have incorporated. We also obtained and incorporated technical corrections on a draft of this report from CBO.

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 issuance 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, the Secretary of the Treasury, the Director of the Congressional Budget Office, and the Director of the Office of Management and Budget. We will make copies available to others on request. In addition, this report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions regarding this report, please contact me or James McDermott, Assistant Director, at (202) 512-8678. Other key contributors to this report were Nancy Eibeck and Josie Sigl.

Thomas J. McCool

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

Scope and Methodology

To describe the Federal Reserve System's rationale for maintaining a capital surplus account and to understand the capital accounts held at the Reserve Banks, we interviewed Federal Reserve Board officials primarily from the Division of Monetary Affairs and the Division of Reserve Bank Operations and Payment Systems. We reviewed and analyzed sections of the Federal Reserve Act pertaining to the paid-in capital and surplus transfers and the Consolidated Appropriations Act of 2000. We also reviewed the financial statements of the Reserve Banks from 1996 to 2001.

To review the policies and practices of foreign central banks regarding accounts that serve similar functions as the capital surplus account, we judgmentally selected four central banks: the Bank of Canada, the Bank of England, the Bundesbank, and the European Central Bank. To verify our interpretation of their published reports, legal requirements, and financial statements, we contacted members of the staffs of the Bank of England and Her Majesty's Treasury (Treasury of the United Kingdom), the Bank of Canada, the Bundesbank, and the European Central Bank. We collected and reviewed annual financial statements from the four central banks for the years from 1996 to 2001 to compare/contrast capital and surplus accounts, and asset and liability structures. The comparability of these data with the Federal Reserve Board is limited, however, due to differences in accounting practices.

To describe the Reserve Banks' use of the capital surplus account from 1989 to 2001, we analyzed historical data on weekly losses for all 12 Reserve Banks. These data included the net income or loss of the prior Wednesday, the amount of weekly loss, the amount of the Treasury payment, the amount of surplus withdrawn, the amount in the undistributed net income, and the amount in the surplus before and after the weekly loss. Federal Reserve Board staff collected the data from the 12 Reserve Banks' balance sheet information. We did not audit Reserve Bank accounting from which the data on the weekly losses were derived. Also, we did not review any weeks during the time period that the Reserve Bank revenues and gains for a week were greater than the expenses. The data we reviewed were for those weeks when the expenses and losses were greater than the revenues and gains for each of the 12 Reserve Banks. The data are limited on the identification of the cause of the weekly losses incurred by the Reserve Banks. Federal Reserve Board staff confirmed the cause for only those weekly losses that occurred during the time period of 1997 to 2001.

We also analyzed the Board of Governors of the Federal Reserve System's *Annual Reports* from 1996 to 2001 to determine the trend in both the capital surplus and the paid-in capital accounts. To determine the reason for the growth in the paid-in capital accounts, we reviewed Federal Reserve Board data on the aggregate member bank capital and surplus from 1996 to 2001. According to Federal Reserve Board staff, the aggregate data provided us were drawn from bank call reports.

To describe and determine the potential effects of reducing or eliminating the surplus account on the federal budget and the economy, we interviewed officials from the Federal Reserve Board, the Department of the Treasury, the Office of Management and Budget, and the Congressional Budget Office (CBO). We reviewed the Consolidated Appropriations Act of 2000 (P.L. 106-113, Section 302). We also reviewed reports from CBO on the Reserve Banks' transfers of net earnings to the Treasury.

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

Comments from the Federal Reserve Board

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

DIVISION OF MONETARY AFFAIRS

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: Issues Related to the Surplus Account.* The report makes clear that, while the benefits of the surplus account can be debated, it is costless to the taxpayer and the Treasury. We appreciate the efforts of your staff in responding to our earlier comments.

Sincerely,

Vincent R. Reinhart

Vincent R. Reinhart
Director

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