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City

Before the Task Force on Monetary Policy, Treasury Market Resilience, and Economic  
Prosperity of the Committee on Financial Services

Examining the Structure of the Federal Reserve System

June 12, 2026  
Oklahoma City, Okla.

Thank you, Chairman Lucas and Ranking Member Vargas, and other members of the Task Force for holding this hearing and inviting me to testify on the structure of the Federal Reserve System. Democracy demands accountability from its most powerful institutions. The Federal Reserve is no exception.

Three years ago, I stepped down from my post as president of the Federal Reserve Bank of Kansas City, having reached mandatory retirement and concluding some 40 years of service to the Federal Reserve System. It was an honor to serve the nation's central bank and to represent a region that includes all or part of seven states: Missouri, Kansas, Nebraska, Oklahoma, Colorado, Wyoming, and New Mexico.

The robust and contentious public debate that preceded the signing of the Federal Reserve Act in 1913 reflects something deep and durable in the American character: a wariness of concentrated power and a preference for decentralized institutions. This public sentiment influenced Congress to shape the institution in a way that would garner the trust and confidence of the American public. The result was a decentralized structure that exists today with locations across the country operating under a rigorous system of checks and balances.

It is my view that the decentralized structure has positioned the Federal Reserve to effectively achieve its broad objectives for the economy over the past 112 years. My comments this morning focus on how the structure of the Federal Reserve System enhances its effectiveness across three key dimensions: public trust, operational effectiveness, and independent thinking.

## **Structure enhances public trust**

The Federal Reserve Act established a framework for the nation's central bank that departed materially from that of the First and Second Banks of the United States. Indeed, it departed materially from existing central bank structure and governance in other countries.

Congress rightly understood that the monolithic structure of the nation's first two central banks was ill-suited to represent and serve the diverse interests, geographies and industries that make up the U.S. economy. The Federal Reserve's founders recognized that the long-term success and credibility of the institution would rely on its ability to gain support outside the Washington-New York corridor of political and financial interests.

To that end, Congress created a government agency — the Board of Governors in Washington, D.C. — composed of individuals who are nominated by the president and confirmed by the Senate to serve 14-year terms. The Board of Governors plays an important public oversight role for the entire system, without which a meaningful role for the regional Reserve Banks would not likely be acceptable to the public. However, to ensure there was appropriate balance and representation, the Federal Reserve Act also called for Reserve Banks to be located across the country. A committee of cabinet members took several months to arrive at its decision to name the 12 Federal Reserve cities that would serve as the regional arms of the nation's central bank.

This decentralized regional design is not simply about geography. With this structure, private citizens from communities across the nation — representing interests such as agriculture, labor, small and large business, higher education, healthcare and community development — contribute meaningfully to operational oversight and monetary policy deliberations. Each Reserve Bank is overseen by a local Board of Directors composed of community and business leaders from diverse sectors across each of the 12 regions who share governance responsibility for Reserve Bank operations with the Board of Governors. In addition to these head office Reserve Bank boards, individuals serve as directors on the board of Federal Reserve branch offices. All told, the individuals across the country who serve as Federal Reserve directors provide real-time economic information for the Federal Reserve to consider in its policy formulation. In addition, through their experiences as leaders in various sectors of our economy, directors offer an independent perspective on Reserve Bank operations, budgetary issues, and other strategic challenges.

## **Structure improves operational effectiveness**

Over the past century, the Federal Reserve's local connections have proven to be valuable in carrying out its responsibilities. Whether responding to a crisis, delivering financial services, or supervising banks, the Reserve Banks' deep understanding of regional interests has facilitated effective operational performance.

Importantly, the Reserve Banks are designed to understand credit availability issues at the local level. You need not go back to 1913 to find an example that underscores this. As financial markets seized up in the 2008 financial crisis, the Board of Governors and the Federal Reserve Bank of New York focused their efforts and resources on designing liquidity facilities to ease financial conditions. Even as resources were dedicated to pulling Wall Street out of the depths of the financial panic, problems developed in other parts of the country that needed to be addressed, including in the Kansas City Fed's region where hundreds of small and regional banks serve their communities.

Among the roles served by the regional Reserve Banks is the statutory responsibility to act as "lender of last resort" to depository institutions in the region. Specifically, the Federal Reserve is charged with lending against collateral to solvent institutions, making its role as a bank supervisor complementary to the ability to confirm eligibility to borrow on short notice.

In the case of the Kansas City Fed, serving as a lender of last resort across its seven-state region means leveraging relationships and accessing information on hundreds of institutions. This information is a particularly critical resource during crisis situations where a deep familiarity with local economic conditions and firms means the Fed can move quickly to connect these entities with necessary services when access to normal funding sources unexpectedly disappears.

Likewise, the regional Reserve Bank is able to gauge the local effects of financial market conditions and economic drivers through its role in supervising banks. Although considerable attention is focused on systemic risk and systemically important financial institutions, the Federal Reserve's regional connections to thousands of community banks and 50 state banking departments provide essential information about the economic health of small business, regional economies, credit conditions and the impact of broader regulatory issues.

Through the Reserve Banks' presence in their respective communities, regional issues can be addressed with the expertise and knowledge that a regional Reserve Bank is equipped to

provide. Having been so recently reminded during the 2020 pandemic crisis that access to credit is critical to the economic success for communities large and small, it is quite feasible that if Congress were to design the Federal Reserve System today, it might well choose to have 50 Reserve Banks rather than just 12.

### **Structure fosters independent thinking**

The system, by design, is intended to include a wide range of perspectives, and the Reserve Banks contribute importantly to this diversity. Many have criticized this feature by suggesting that the cacophony of voices sends mixed signals. Yet, other public institutions reflect similar democratic processes where a mosaic of perspectives and input is sometimes messy. Essential to sound outcomes are leadership and governing processes that bring these voices together for the purpose of decision making. The same is true for the Federal Open Market Committee (FOMC).

The FOMC has a long-established process that provides for discussion and debate of policy options. Even so, the decision-making process itself is quite clear: 12 participants — seven from the Board of Governors and five from the Reserve Banks — cast votes at each meeting and the majority defines the policy action with a statement articulating its rationale. A \$32 trillion economy with complex dynamics is well-served by this process, which includes a range of viewpoints and inputs.

The FOMC, by design, allows for dissenting views. This feature recognizes the value Americans place on independent thinking. Some have argued: Why not keep differing views internal and present a united or consensus view to the public? Wouldn't solidarity give more confidence and clarity to the public?

Making differing views available to the public serves to clarify and deepen understanding of issues. It is the duty of each FOMC participant to express their views. To suggest that FOMC members should appear to be unanimous in voting records is to suggest that diverse perspectives are not valued, and it underestimates the public's ability to discern intellectual honesty.

Finally, independent, stable and informed leadership is especially important to the Federal Reserve's policymaking process. Policy decisions have broad impact and benefit from the institution's research, thoughtful analysis and public input. Experience and informed judgment are as important to good policy as academic and theoretical frameworks.

## **Conclusion**

The Federal Reserve's history is important, but it is only helpful to the extent that it positions decisionmakers to prepare for the considerable challenges that await the central bank in the years to come. Those challenges seem likely to include appropriately calibrating the settings of monetary policy in a changing economy, effectively supervising institutions as fundamental changes take place in the financial system, and ensuring a safe, efficient and accessible payments system.

The Federal Reserve's structure provides an opportunity to engage the public and to reflect on the values that have allowed the institution to serve the country.<sup>1</sup> Its defining characteristics, if embraced, can continue to serve as a source of strength for the nation in the future. As one of the key architects of the Federal Reserve System, former Senator Robert Owen of Oklahoma described the role of the regional reserve banks within the Federal Reserve System: "Their function must be to protect the commerce of the nation, to stabilize the interest rate and to give permanency to the prosperity which this country ought to enjoy continuously."

That sentiment rings as true today as it did in 1913.

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<sup>1</sup> For more on the Federal Reserve's history, visit <http://www.federalreservehistory.org/>.