

Updated January 4, 2021

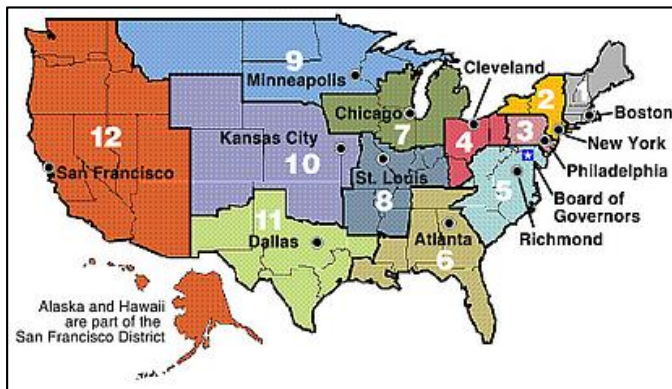
Introduction to Financial Services: The Federal Reserve

Structure of the Federal Reserve

The Federal Reserve Act (12 U.S.C. 221 et seq.) created the Federal Reserve (Fed) as the nation's central bank in 1913. The Fed is composed of 12 regional Federal Reserve banks overseen by a Board of Governors in Washington, DC.

Figure 1 illustrates the city in which each bank is headquartered and the area of each bank's jurisdiction. The Board is composed of seven governors nominated by the President and confirmed by the Senate. The President selects (and the Senate confirms) a chair and two vice chairs from among the governors, one of whom is responsible for supervision. The governors serve nonrenewable 14-year terms, but the chair and vice chairs serve renewable 4-year terms. Jerome Powell's term as chair began February 5, 2018. Board members are chosen without regard to political affiliation. Regional bank presidents are chosen by their boards, not by the President, with the approval of the Board of Governors.

Figure 1. Federal Reserve Districts



Source: Federal Reserve.

In general, policy is formulated by the board and carried out by the regional banks. Monetary policy decisions, however, are made by the Federal Open Market Committee (FOMC), which is composed of the seven governors, the president of the New York Fed, and four other regional bank presidents. Representation for these four seats rotates among the other 11 regional banks. The FOMC meets at least every six weeks to review the stance of monetary policy.

The Fed's budget is not subject to congressional appropriations or authorizations. The Fed is funded by fees and the income generated by securities it owns. Its income exceeds its expenses, and it remits most of its net income to the Treasury, where it is used to reduce the federal debt.

The Fed's capital consists of stock and a surplus. The surplus is capped at \$6.825 billion by law. (Congress reduced the Fed's financial surplus as a budgetary "pay for" in P.L. 114-94, P.L. 115-123, and P.L. 115-174.) Private banks regulated by the Fed buy stock in the Fed to become

member banks. Membership is mandatory for national banks, but optional for state banks. The stock pays dividends of 6% for banks with less than \$10 billion in assets and the lower of 6% or the 10-year Treasury yield for banks with more than \$10 billion in assets. Stockholders choose two-thirds of the boards at the regional Fed banks.

Responsibilities of the Federal Reserve

The Fed's responsibilities fall into four main categories: monetary policy, lender of last resort, prudential supervision of certain banks and other financial firms, and provision and oversight of payment systems.

Monetary Policy. The Fed's primary monetary policy instrument is the federal funds rate (the overnight bank lending rate). The Fed influences interest rates to affect interest-sensitive spending on capital investment, consumer durables, and housing. Interest rates also indirectly influence the value of the dollar and, therefore, spending on exports and imports. The Fed reduces rates to stimulate economic activity and raises rates to slow activity. Monetary policy is considered a blunt instrument that cannot be targeted to affect specific regions, certain industries, or the income distribution.

Formerly, the Fed targeted the federal funds rate primarily through *open market operations*—the purchase and sale of U.S. Treasury securities, mainly from primary dealers (who specialize in trading government securities), in the secondary market. Often, these transactions were made on a temporary basis using repurchase agreements, known as *repos*. The Fed sets reserve requirements and the interest rate it pays banks to hold reserves. Since the 2007-2009 financial crisis, the Fed has primarily used a new method for targeting interest rates that relies on banks maintaining large reserves at the Fed and paying banks interest on those reserves. In addition, monetary policy can involve foreign exchange operations, although these are rare. Open market and foreign exchange operations are conducted by the New York Fed per the FOMC's directives. The Fed influences growth in the money supply through its control over bank reserves and currency in circulation.

During the financial crisis, the Fed reduced the federal funds rate to zero and conducted large-scale asset purchases of Treasury- and mortgage-backed securities from 2008 to 2014—known as *quantitative easing (QE)*—that quintupled the size of its balance sheet. The Fed then began to *normalize* monetary policy. From 2015 to 2018, the Fed initiated a series of increases in the federal funds rate. From 2017 to 2019, the Fed modestly reduced the size of its balance sheet. However, the Fed began to cut rates and expand its balance sheet again in 2019, which remains much larger than its pre-crisis size. A large balance sheet has boosted Fed remittances to the Treasury in recent years.

Lender of Last Resort. Despite their name, Federal Reserve banks do not carry out any banking activities, with one limited exception. The Fed traditionally acts as lender of last resort by making short-term, collateralized loans to banks through its discount window. The Fed generally sets the *discount rate* charged for these loans above market rates. In normal market conditions, the Fed's lending operations are minimal. In crises, the Fed has emergency authority to extend its lender of last resort function to nonbank firms and markets.

Regulation. The Fed regulates bank holding companies (including the largest banks), some foreign banks, and some state banks. The Fed's regulatory responsibilities overlap with those of other bank regulators—the Consumer Financial Protection Bureau (CFPB), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC). The Fed shares responsibility for maintaining financial stability with the Financial Stability Oversight Council (FSOC) and its members. FSOC is a council of regulators, including the Fed, headed by the Treasury Secretary. The Fed participates in intergovernmental fora, such as the Financial Stability Board and the Basel Committee on Banking Supervision, alongside other U.S. agencies.

Payment Systems. The Fed operates key payment systems, including check clearing and interbank transfers, and oversees private-sector payment systems. In 2019, the Fed announced that it would create a real-time payment system for instantaneous payment settlement. It also acts as the federal government's fiscal agent—federal receipts and payments flow through Treasury's accounts at the Fed.

Policy Issues

COVID-19 Pandemic Response. In response to the pandemic, the Fed swiftly lowered interest rates to zero, increased its use of QE and repos, and announced a plethora of emergency programs to stabilize the financial system and assist entities cut off from credit markets. The CARES Act (P.L. 116-136) provided at least \$454 billion to support some of these programs, including the Main Street Lending Program and the Municipal Liquidity Facility. The programs were much smaller than their announced size and expired at the end of 2020. Congress has debated (1) whether the programs should be revived given financial conditions have normalized but pandemic disruptions persist, and (2) whether they fell short of their intended size because private credit conditions improved or because the programs' terms were too stringent.

Congressional Oversight. Congress has delegated monetary policy to the Fed but conducts oversight to ensure the Fed meets its statutory mandate of “maximum employment, stable prices, and moderate long-term interest rates.” The Fed has defined stable prices as a longer-run goal of 2% inflation. Following a 2020 review of its monetary policy strategy, tools, and communications, the Fed pledged to allow inflation to run slightly above 2% to make up for inflation recently falling short of 2%.

The Fed is more independent from Congress and the Administration than most agencies. Economists have

justified the Fed's independence on the grounds that monetary policy decisions that are insulated from short-term political pressures result in better economic outcomes. There is an inherent trade-off between independence and accountability, however.

Nevertheless, the Fed's independence has limits. Contrary to popular belief, the Government Accountability Office already audits the Fed upon congressional request, but it is prohibited by law (31 U.S.C. 714) from conducting economic analyses of monetary or lender-of-last-resort activities. The Fed is statutorily required to testify semiannually before and present a written report to the committees of jurisdiction. Congress has debated whether the Fed should report to it more frequently and in more detail. In the 116th Congress, H.R. 974 would have required the vice chair for supervision to provide written testimony and the chair to testify if the vice chair position is vacant.

Congress has also debated what types of information the Fed should publicly disclose. Disclosure helps Congress and the public to better understand the Fed's actions. Up to a point, this makes monetary and regulatory policy more effective, but too much disclosure could make both less effective because they rely on market-sensitive and confidential information. The Dodd-Frank Act (P.L. 111-203) required the Fed to release information with a lag on the identities of all borrowers and the terms of borrowing.

Regulatory Relief. The Fed has recently been implementing *regulatory relief* for large and small banks. Finding the optimal trade-off between the benefits and costs of financial regulation continues to be debated. Congress has also been concerned about whether the Fed is susceptible to *regulatory capture*, the concept that regulated entities have undue influence over regulation.

Diversity. Some Members of Congress have expressed concern over a lack of diversity at the Fed. The Dodd-Frank Act created Offices of Minority and Women Inclusion for the Federal Reserve System. In the 116th Congress, H.R. 281 would have required diverse candidates to be interviewed when selecting Fed regional bank presidents.

Central Bank Digital Currency (CBDC). With the rise of private digital currencies, such as Bitcoin, some have called for the Fed to create a CBDC. Critics question whether the costs of introducing a CBDC would outweigh the benefits. Open questions remain about who could hold CBDCs, what they could be used for, and whether individuals would be able to store CBDCs in personal accounts at the Fed.

CRS Resources

CRS Report R46411, *The Federal Reserve's Response to COVID-19: Policy Issues*, by Marc Labonte

CRS Report RL30354, *Monetary Policy and the Federal Reserve: Current Policy and Conditions*, by Marc Labonte

Marc Labonte, Specialist in Macroeconomic Policy

Disclaimer

This document was prepared by the Congressional Research Service (CRS). CRS serves as nonpartisan shared staff to congressional committees and Members of Congress. It operates solely at the behest of and under the direction of Congress. Information in a CRS Report should not be relied upon for purposes other than public understanding of information that has been provided by CRS to Members of Congress in connection with CRS's institutional role. CRS Reports, as a work of the United States Government, are not subject to copyright protection in the United States. Any CRS Report may be reproduced and distributed in its entirety without permission from CRS. However, as a CRS Report may include copyrighted images or material from a third party, you may need to obtain the permission of the copyright holder if you wish to copy or otherwise use copyrighted material.