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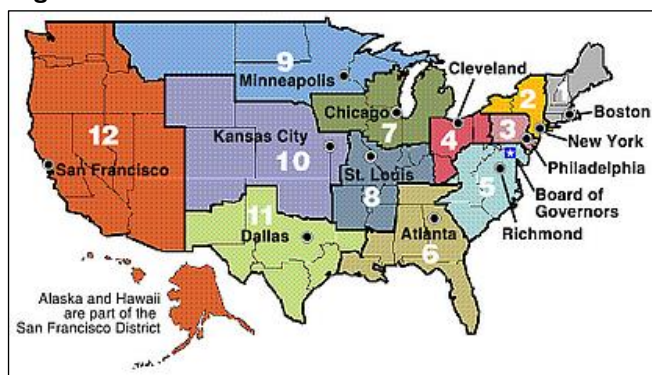
Introduction to Financial Services: The Federal Reserve

Structure of the Federal Reserve

The Federal Reserve Act of 1913 (12 U.S.C. 221 et seq.) created the Federal Reserve (Fed) as the nation's central bank. 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 four-year terms. Board members are chosen without regard to political affiliation. Regional bank presidents are chosen by their boards 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 federally chartered banks but optional for state-chartered 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. Member banks 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, regulation of certain banks and other financial firms, and provision and oversight of certain 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. The Fed holds these securities as assets on its balance sheet. Often, these transactions were made on a temporary basis using repurchase agreements, known as *repos*. 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. The Fed sets that interest rate to influence the federal funds rate. 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, which are largely liabilities on its balance sheet.

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 increased the size of its balance sheet. Following a period when rates rose and the balance sheet shrunk, the Fed began to cut rates and expand its balance sheet again in 2019. At the onset of the pandemic, the Fed swiftly lowered interest rates to zero and increased its use of QE and repos to boost

liquidity. This caused the balance sheet to double in 18 months, which has boosted Fed remittances to the Treasury.

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. In response to the pandemic, the Fed announced an alphabet soup 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 in 2020.

Regulation. The Fed regulates bank holding companies (including the largest banks), some foreign banks, and some state-chartered 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 some private-sector payment systems. The Fed is planning to launch FedNow, a real-time payment system for instantaneous payment settlement, in 2023. It also acts as the federal government's fiscal agent—federal receipts and payments flow through Treasury's accounts at the Fed.

Mandate and 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” (12 U.S.C. 225a). The Fed has defined stable prices as a longer-run goal of 2% inflation. In 2020, the Fed pledged to allow inflation to run slightly above 2% to make up for inflation previously falling short of 2%.

The Fed is more independent from Congress and the Administration than most agencies are. 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. The chair and vice chair for supervision are statutorily required to testify semi-annually before the committees of jurisdiction, and the committees

regularly conduct other hearings on the Fed (12 U.S.C. 225b and 247b).

Policy Issues

Monetary Policy Normalization and Inflation. In 2021 and 2022, inflation has risen to levels last seen in the 1980s. This has led to debate over how quickly the Fed should normalize monetary policy (i.e., remove the extraordinary stimulus from the pandemic). In March 2022, the Fed began raising interest rates and ended its asset purchases. In June 2022, the Fed allowed its balance sheet to begin to gradually shrink. However, the Fed expects additional rate hikes will be needed in 2022 to restore low inflation, and critics question whether those hikes will be sufficient.

Diversity. Some Members of Congress have expressed concern over a lack of diversity at the Fed and in the banking sector and believe that the Fed could do more to eliminate racial disparities. The Dodd-Frank Act (P.L. 111-203) created Offices of Minority and Women Inclusion for the Federal Reserve System. H.R. 2543 would require the Fed to exercise its duties to foster the elimination of (and testify on its efforts to eliminate) racial disparities. H.R. 2516 would require the Fed (and other bank regulators) to include diversity in their supervisory ratings of banks.

Central Bank Digital Currency (CBDC). With the rise of private digital currencies, such as Bitcoin, some have called for the Fed to create a “digital dollar” or CBDC. The Fed has not yet taken a position on the desirability of a CBDC but “does not intend to proceed with issuance of a CBDC without clear support from the executive branch and from Congress, ideally in the form of a specific authorizing law.” Critics question whether the costs of introducing a CBDC would outweigh the benefits. Policymakers have debated how to balance privacy and preventing illicit activity and whether individuals should be able to store CBDCs in personal accounts at the Fed.

Climate Change. In 2020, the Fed joined the Network for Greening the Financial System, a group of over 80 central banks and regulators focused on climate-related risks. In 2021, the Fed created two internal committees related to climate risk and announced they were developing climate scenario analysis to measure banks' exposure to climate risk. Some critics believe the Fed should be doing more to combat climate change. Other critics believe that climate change is outside of the Fed's mission and the Fed lacks the tools to effectively address it.

CRS Resources

CRS In Focus IF11751, *Introduction to U.S. Economy: Monetary Policy*, by Marc Labonte

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

CRS Report R46890, *Inflation in the Wake of COVID-19*, by Marc Labonte and Lida R. Weinstock

CRS Report R46850, *Central Bank Digital Currencies: Policy Issues*, by Marc Labonte and Rebecca M. Nelson

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