Congressional Research Service
Informing the legislative debate since 1914

Federal Reserve: Policy Issues in the 119th Congress

February 3, 2025

Congressional Research Service
https://crsreports.congress.gov
R48390

Federal Reserve: Policy Issues in the 119th Congress

SUMMARY

R48390

February 3, 2025

Marc Labonte
Specialist in Macroeconomic Policy

The responsibilities of the Federal Reserve (Fed) fall into four main categories: monetary policy, regulation of certain banks and other financial firms, provision and oversight of certain interbank payment systems, and lender of last resort. This report summarizes policy issues for Congress in each of these areas, as well as issues surrounding independence and congressional oversight.

Monetary policy. The Fed has a statutory mandate of maximum employment and price stability. In normal conditions, the Fed conducts monetary policy by targeting the federal funds rate, a short-term interest rate. The Fed raised short-term interest rates between March 2022 and July 2023 in an effort to reduce inflation, which ran well above the Fed's 2% inflation target from 2021 to 2023. As inflation has fallen, the Fed began reducing interest rates in September 2024—before inflation had reached 2%.

Following economic crises, the Fed has made large-scale asset purchases, expanding its balance sheet as an additional monetary policy tool. The balance sheet almost doubled to $8.9 trillion following the COVID-19 pandemic, and now the Fed is gradually reducing its size, with uncertainty about when that process will end. The Fed finances its operations primarily with the income earned on these assets and remits its net income to the Treasury. Higher interest rates have caused its net income to turn negative and its remittances to temporarily fall to zero for the first time in decades.

Regulation. The Fed regulates bank holding companies, some state-chartered banks, and some U.S. operations of foreign banks. Large bank holding companies are subject to enhanced prudential regulation administered by the Fed. Congress is interested in a number of Fed regulatory issues. The failure of Silicon Valley Bank (SVB) in the spring of 2023 raised questions about whether the Fed's supervision of SVB was deficient or whether regulatory requirements were inadequate. The "Basel III endgame" proposed rule would strengthen capital requirements for large banks. The Fed's other current regulatory priorities include managing climate risk, large bank stress tests, and what access crypto firms should have to the banking system and Fed services, such as master accounts.

Payments. The Fed operates parts of the wholesale payment system in competition with the private sector while also setting risk-management standards for private wholesale payment system operators. In July 2023, the Fed introduced a real-time payment system, FedNow. Congress has debated whether to prohibit the Fed from issuing a central bank digital currency (or "digital dollar") and whether to give the Fed jurisdiction over payment stablecoin issuers.

Lender of last resort. The Fed was created as a "lender of last resort" to provide liquidity to the banking system during periods of financial instability. The Fed created emergency facilities to support the financial system during the 2007-2009 financial crisis, the COVID-19 pandemic, and bank failures in 2023. Borrowing—and problems with borrowing—by failed banks in 2023 have raised questions about its role as lender of last resort.

Independence. The Fed has significant independence from Congress and the Administration to fulfill its duties, but Congress retains oversight responsibilities. The goals of independence and oversight can be in tension, and Congress has grappled with balancing the two through proposals to increase public disclosure and accountability. President Trump and some Members of Congress have publicly questioned the Fed's monetary policy decisions—in contrast to the traditional deference shown to the Fed on monetary policy.

Contents

Figures

Contacts

Introduction

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's responsibilities fall into four main categories: monetary policy, regulation of certain banks and other financial firms, provision and oversight of certain payment systems, and lender of last resort. The Fed has significant independence from Congress and the Administration to fulfill its duties, but Congress retains oversight responsibilities. This report provides an overview of current policy issues in each of those four areas, as well as oversight and independence. Each section provides background, recent Fed or congressional action, and policy questions for Congress.

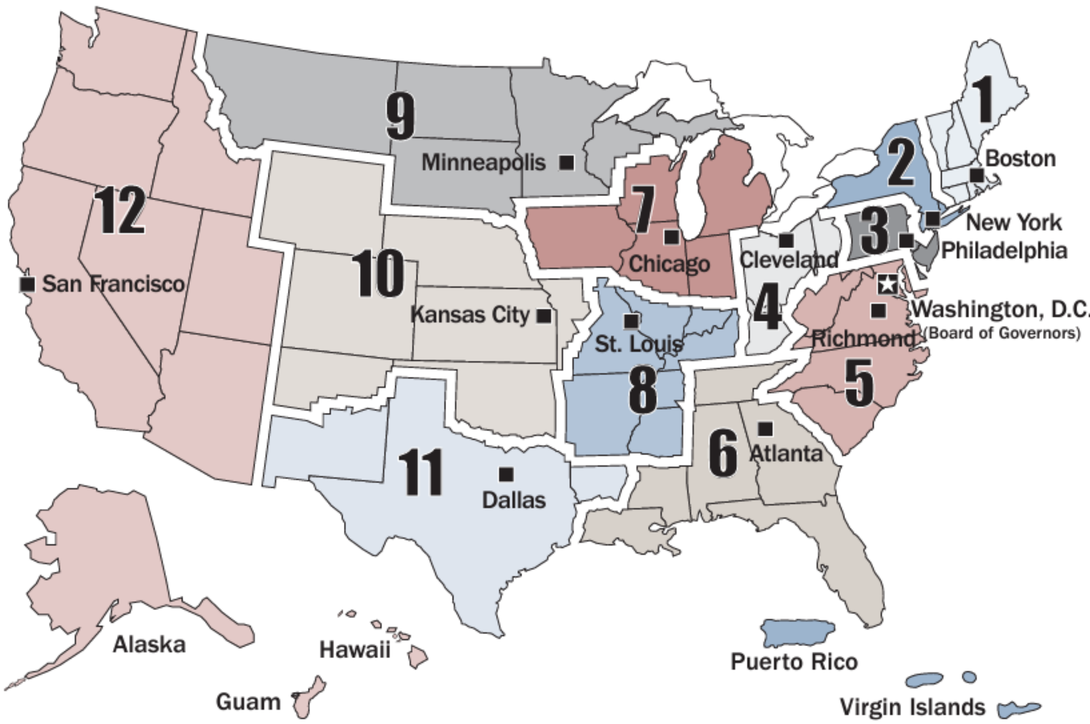
The Fed's powers and mission have evolved since its creation. Its independence gives its latitude to act quickly and decisively. For that reason (and its status as off budget and self-financed), Congress has often expressed interest in expanding the Fed's responsibilities into new public policy areas. However, the Fed's tools are limited. Expanding the Fed's responsibilities into new areas necessarily causes the Fed to grapple with more political trade-offs, which makes it harder to justify its independence in a democratic system. Because its tools are limited, giving the Fed new responsibilities can also dilute its effectiveness.

Organizational Structure of the Fed

The Federal Reserve System is composed of 12 regional Federal Reserve banks overseen by the 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 creators of the Fed intended to create a decentralized system to allay concerns that power would be concentrated in New York, the primary financial center. Contradictions between this desire and the duties of the Fed (such as monetary policy), which were more effectively carried out when centralized, led to a series of reforms in the early years to make the system more centralized.[1] Competing desires for a centralized system and a decentralized system are at the root of some policy proposals to change the Fed's structure.

[1] Roger Lowenstein, *America's Bank* (New York: Penguin, 2015).

Figure 1. Federal Reserve Districts



Source: Federal Reserve.

The board is composed of seven governors nominated by the President and confirmed by the Senate. Under Title 12, Section 241, of the *U.S. Code*, the President is required to make selections "with a due regard to a fair representation of financial, agricultural, industrial, and commercial interests" and may not select more than one nominee from any of the 12 Federal Reserve districts. One of the governors must have "primary experience working in or supervising community banks." The President nominates (and the Senate confirms) a chair and two vice chairs from among the governors, one of whom is responsible for supervision of the entities the Fed regulates. The governors serve nonrenewable 14-year terms, but the chair and vice chairs serve renewable four-year terms. There is no limit on the number of board members that can be chosen from one political party (officially, board members do not have any political affiliation), unlike many other federal regulators and independent agencies. The governors may be removed only "for cause," a higher standard than the "at will" removal standard that applies to Cabinet members and many other political appointees.[2] Regional bank presidents are chosen by their boards with the approval of the Board of Governors.

Long terms and a full board mean that President Trump may have the opportunity to appoint only two governors during his current term. However, in practice, few governors serve out their full 14-year terms, so vacancies may arise sooner. The President can choose whether to renominate the chair and two vice chairs sooner—Jerome Powell's term as chair ends in 2026, and Philip Jefferson's term as vice chair ends in 2027. Michael Barr announced that he will step down as vice chair for supervision in February but remain a governor. If the President chooses not to

[2] For more information, see CRS Report R43391, *Independence of Federal Financial Regulators: Structure, Funding, and Other Issues*, by Henry B. Hogue, Marc Labonte, and Baird Webel.

renominate the incumbents, he can currently replace them with outside candidates only if some current governor (including the current chair and vice chairs) decides to step down before his or her term as governor has ended.[3]

In general, policy is formulated by the Board of Governors and carried out by the regional banks, with one notable exception: Monetary policy is 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 is chaired by the Fed chair.

The Fed's budget is not subject to the congressional appropriation or authorization processes. The Fed is funded by fees paid by financial institutions that use its services and mostly by the income generated by securities it owns. As discussed below,[4] its income typically exceeds its expenses, and it remits most of its net income to the Treasury, where it is added to general revenues. By statute, the Consumer Financial Protection Bureau (CFPB) is funded by a transfer from the Fed in an amount set by the CFPB director.

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.[5]) Private banks regulated by the Fed must buy stock in the Fed to become *member banks*. Membership is mandatory for federally chartered banks but optional for state-chartered banks. Unlike common stock in a private company, this stock does not confer ownership control. However, it does provide the banks with the right to choose two-thirds of the directors of the boards of the 12 Fed regional banks (of which one-third are representatives of the banking industry and one-third are representatives of other interests). The stock also pays a dividend set in statute. As amended by P.L. 114-94, the dividend is 6% for banks with less than $10 billion in assets (as of 2015 and adjusted for inflation thereafter)—above market rates in recent decades—and the lower of 6% or the 10-year Treasury yield for banks with more than $10 billion in assets.

Congress has debated structural changes to the Fed.[6] Policy issues for Congress going forward could include the following:

---

[3] There are historical examples of chairs not being reappointed when their terms expire (most recently, Janet Yellen in 2018) and an example of a President successfully requesting that a chair resign before his term has ended (Thomas McCabe resigned at the request of Harry Truman after McCabe had successfully asserted the Fed's independence from the Treasury over setting interest rates in 1951), but no examples of Presidents removing chairs against their will before their terms have ended. There is also a historical example of a governor remaining on the board after the President did not reappoint him as chair (Marriner Eccles in 1948). Statute is silent and the courts have not had the opportunity to rule on whether chairs or vice chairs could be removed against their will before their terms expire. See Robert L. Hetzel and Ralph F. Leach, "The Treasury-Fed Accord: A New Narrative Account," Federal Reserve Bank of Richmond *Economic Quarterly*, Winter 2001, https://www.richmondfed.org/-/media/RichmondFedOrg/publications/research/economic_quarterly/2001/winter/pdf/hetzel.pdf; Michael C. Jensen, "Marriner S. Eccles Is Dead at 87," *New York Times*, December 20, 1977, https://timesmachine.nytimes.com/timesmachine/1977/12/20/86356088.html?pageNumber=38.

[4] See the section entitled "Losses on the Fed's Balance Sheet."

[5] The acts that statutorily reduced the Fed's surplus are listed at Board of Governors of the Federal Reserve System, "Federal Reserve Board Announces Reserve Bank Income and Expense Data and Transfers to the Treasury for 2021," press release, January 14, 2022, https://www.federalreserve.gov/newsevents/pressreleases/other20220114a.htm.

[6] In the 118th Congress, the House passed H.R. 4790, which would have, among other things, eliminated the position of vice chair for supervision. H.R. 3556 would have, among other things, required the vice chair for supervision to have "primary experience working in, or supervising" banks and provided the other Fed governors a role in formulating regulatory policy.

- Should the current number and location of Federal Reserve banks, which has not changed since their creation over a hundred years ago, be updated to reflect economic and population shifts since then?
- Should smaller banks receive a dividend fixed in statute, or should their dividend adjust with market interest rates, as is the case for larger banks?
- Should banks have seats on the Federal Reserve banks' boards when they are regulated by the Fed, given the inherent conflict of interest in such an arrangement? Or are current safeguards sufficient?
- Should the CFPB have its own funding source or continue to be funded through transfers from the Fed?
- Should Federal Reserve regional banks conduct research and promote policies outside the scope of the statutory duties of the Federal Reserve System? If not, are new statutory restrictions appropriate?
- Should the geographic diversity requirements for board members be repealed or be interpreted more strictly than they have been in practice? Should professional qualification requirements be more specific, or does diverse experience lead to better policy outcomes?
- Should seats on the board be set aside for other interest groups besides community banks? Is it inappropriate to have any seats set aside for specific interest groups?

For more information, see CRS In Focus IF10054, *Introduction to Financial Services: The Federal Reserve*, by Marc Labonte.

Fed Independence and Congressional Oversight

As discussed in the introduction, the Fed has been granted an unusually high degree of independence from Congress and the President.[7] There are some structural characteristics that contribute to the Fed's independence, but independence also stems from culture and norms, such as nonpartisan decisionmaking based on consensus. Norms are a reflection of history, tradition, and the actions of individuals who have led the institution, and they are not immutable—particularly when leadership changes. President Trump in his first term and some Members of Congress from both parties have recently tested the Fed's independence by publicly criticizing its monetary policy decisions and recommending preferred alternatives, but they have not made statutory or other formal changes that would alter its independence.[8] Some have called on President Trump to replace the current chair or vice chair before their terms have expired,[9] which

[7] In terms of relative independence, the Federal Reserve banks are more independent than the Board of Governors is in the sense that they are subject to fewer of the rules that apply to government agencies.

[8] See, for example, Christopher Condon, "Key Trump Quotes on Powell as Fed Remains in the Firing Line," *Bloomberg*, January 28, 2020, https://www.bloomberg.com/news/articles/2019-12-17/key-trump-quotes-on-powell-as-fed-remains-in-the-firing-line; Sen. Sherrod Brown, letter to Chair Jerome Powell, January 30, 2024, https://www.banking.senate.gov/imo/media/doc/monetary_policy_letter_to_the_fed.pdf; Sens. Elizabeth Warren, Sheldon Whitehouse, and John Hickenlooper, letter to Chair Jerome Powell, September 16, 2024, https://www.warren.senate.gov/imo/media/doc/warren_hickenlooper_whitehouse_letter_to_fed_re_september_rate_cut.pdf.

[9] John Yoo and Robert J. Delahunty, "There's Only One Way Trump Can Fix Powell's Opposition at the Fed," *FoxNews.com*, November 14, 2024, https://www.aei.org/op-eds/theres-only-one-way-trump-can-fix-powells-opposition-at-the-fed/; *Wall Street Journal*, "A Federal Reserve Regulator Who Deserves the Boot," December 17, 2024, https://www.wsj.com/opinion/a-federal-reserve-regulator-who-deserves-the-boot-michael-barr-99d9c51f.

would be unprecedented and legally untested, and it would likely be perceived as directly undermining the Fed's independence.[10] (One of the individuals whom critics wanted President Trump to replace, Michael Barr, decided to step down as vice chair for supervision.)

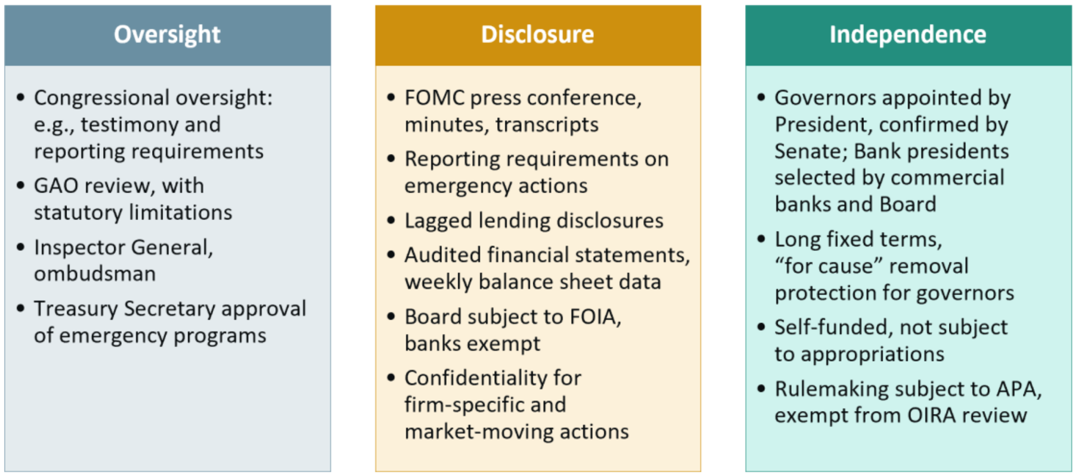
Economists view central bank independence as leading to better monetary policymaking, because, subject to less short-term political pressure, the central bank can choose policies that are optimal under a longer-term horizon. Many economists believe that this results in lower and more stable inflation, because an independent central bank is more willing to raise interest rates to reduce inflation and less tempted to reduce rates to run the economy hot before an election.[11] (The relationship between independence and outcomes in regulation is less clear cut, as regulatory policy inherently faces political trade-offs.) The trade-off to a more independent Fed is less congressional and executive input into and oversight of its actions. Likewise, a potential consequence of closer oversight is that it could reduce the Fed's political independence. The challenge for Congress is to strike the right balance between a desire for the Fed to be responsive to Congress and a desire for the Fed's decisions to be immune from short-term political calculations. Critics of the Fed have long argued for more oversight, transparency, and disclosure. Criticism intensified following the extensive assistance the Fed provided to financial firms during the 2007-2009 financial crisis. In addition, some critics downplay the degree of Fed oversight and disclosure that already takes place. Some studies rank the Fed as one of the more transparent central banks in the world.[12] Examples of Fed oversight, disclosure, and independence are listed in **Figure 2**.

[10] As discussed above, the Federal Reserve Act provides "for cause" removal protections to Fed governors but is silent on the grounds for removal in their leadership capacity beyond granting the positions fixed terms. There is precedent for a President (Truman) successfully requesting a Fed chair to resign.

[11] See, for example, Kristalina Georgieva, "Strengthen Central Bank Independence to Protect the World Economy," International Monetary Fund, March 21, 2024, https://www.imf.org/en/Blogs/Articles/2024/03/21/strengthen-central-bank-independence-to-protect-the-world-economy. The economic argument for independence is not based on the notion that technocratic, nonpolitical experts are better qualified to make good decisions. That may or may not be true, but one can also point to many monetary policy decisions the Fed has made historically that proved to be suboptimal after the fact. (For example, when inflation first became high after the pandemic, some Members of Congress were more concerned than the Fed was initially. Fed officials viewed it as transitory and waited to raise interest rates.) Instead, the economic argument is based on the different incentives that policymakers face when they are shielded from short-term political factors.

[12] N. Nergiz Dincer and Barry Eichengreen, "Central Bank Transparency and Independence," *International Journal of Central Banking*, March 2014. This study finds an increase in Fed transparency between 1998 and 2010. Christopher Crowe and Ellen Meade, "Central Bank Independence and Transparency," *European Journal of Political Economy*, vol. 24, no. 4 (December 2008), p. 763. This study finds a slight decline in Fed transparency between 1998 and 2006. It appears that the authors rate the Fed as less transparent in 2006 than in 1998 because the Fed discontinued its release of money growth targets between those dates.

Figure 2. Examples of Fed Oversight, Disclosure, and Independence



Source: CRS.

Notes: GAO = Government Accountability Office, FOIA = Freedom of Information Act, APA = Administrative Procedures Act, OIRA = Office of Information and Regulatory Affairs.

Although oversight and disclosure are often lumped together, they are separate issues. Oversight entails independent evaluation of the Fed; disclosure is an issue of what internal information the Fed releases to the public. Disclosure helps Congress and the public 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 confidential, market-moving information.

The failure of Silicon Valley Bank (SVB), a large bank whose primary regulator was the Fed, in the spring of 2023 led the 118th Congress to focus on congressional oversight and transparency of Fed supervision.[13] Of all the Fed's duties, transparency surrounding supervision is the most limited, because disclosure of details about individual banks could move markets and, in the worst-case scenario, cause bank runs. Even aggregate, anonymized data on supervision is currently limited. This lack of transparency makes it hard to judge whether the Fed's approach to supervision is appropriate or effective.

Policy issues for Congress going forward could include the following:

- What is the right balance between Fed independence and oversight and accountability?
- Have existing statutory restrictions interfered with the Government Accountability Office's ability to evaluate the Fed on issues of congressional interest?
- Has disclosure of lending records since the 2007-2009 financial crisis created any stigma that has reduced the effectiveness of Fed lending programs? Has it buttressed public confidence that Fed lending programs do not result in favoritism or conflicts of interest? Would greater congressional access to private

[13] See, for example, S. 2190 and H.R. 3556 in the 118th Congress. H.R. 3556 would also have increased disclosures surrounding Fed lending and open market transactions.

lending records improve oversight or risk undermining a bank's financial health through improper public release?

- Should more federal statutes applying to the board and other government agencies (such as the Freedom of Information Act) be applied to Federal Reserve banks, or should they continue to be exempted? Do these exemptions effectively place the banks beyond the reach of congressional oversight?
- Should Congress be kept better informed about banks' supervisory problems, or would this risk undermining a bank's financial condition through improper public release? Does Congress have sufficient aggregate information about bank supervision to support its oversight role?
- Does the 2021 trading scandal involving Federal Reserve bank presidents indicate that more congressional oversight is needed?[14] Does the Fed's 2022 rules banning trading by leadership obviate the need for legislation to address that scandal?[15]
- Should the Fed comply with recent executive orders affecting the federal government and how would doing so affect its independence?

For more information, see CRS Report R42079, *Federal Reserve: Oversight and Disclosure Issues*, by Marc Labonte.

Monetary Policy

Monetary policy refers to the Fed's influence over interest rates and the money supply to alter economic activity. Congress has delegated monetary policy to the Fed but conducts oversight to ensure that the Fed meets its statutory mandate from 1977 of "maximum employment, stable prices, and moderate long-term interest rates" (12 U.S.C. §225a). The first two goals are referred to as the dual mandate. Since 2012, the Fed has defined *stable prices* as 2% inflation, measured as the annual percentage change in the Personal Consumption Expenditures (PCE) price index.

Monetary Misconceptions

There are many common misconceptions surrounding the Fed and monetary policy, some involving obsolete practices. This text box highlights a few, with the misconception in bold:

- **The Fed conducts monetary policy by buying and selling Treasury securities.** This is the classic textbook explanation of how the Fed set the federal funds rate (FFR), but this method has not been used since 2008. The Fed's new ample reserves framework makes "open market operations" ineffective. Now the Fed targets the FFR by setting the interest rates it controls (see **Figure 3**) and buys Treasury (and other) securities when it wants to expand the size of its balance sheet. Even before 2008, the Fed mainly used repurchase agreements (repos) instead of outright transactions to set the FFR.
- **The Fed sets all interest rates.** The vast majority of interest rates in the economy are market rates determined by supply and demand. That includes the Fed's target of monetary policy, the FFR. The Fed does not set the FFR—rather, it uses its tools to keep the FFR within the Fed's target range of 0.25 percentage

[14] For background, see Brian Cheung, "A Timeline of the Federal Reserve's Trading Scandal," *Yahoo!news*, January 10, 2022, https://news.yahoo.com/a-timeline-of-the-federal-reserves-trading-scandal-104415556.html.

[15] In the 117th Congress, Senate Banking Committee Chair Sherrod Brown introduced S. 3076 to prohibit financial trading by Fed leadership. In February 2022, the FOMC adopted a new policy prohibiting trading by leadership. See FOMC, *Investment and Trading Policy for FOMC Officials*, February 17, 2022, https://www.federalreserve.gov/monetarypolicy/files/FOMC_InvestmentPolicy.pdf. The policy was extended to additional employees in 2024. See FOMC, "Federal Open Market Committee Announces Updates That Further Enhance Its Policy on Investment and Trading," press release, January 31, 2024, https://www.federalreserve.gov/newsevents/pressreleases/monetary20240131c.htm.

points. The Fed does set a few interest rates it controls directly, however: the interest on bank reserves held at the Fed, the discount rate charged at the discount window, and the borrowing and lending rates levied at its repo facilities.

- **The discount window charges a penalty rate.** It is often said that this is done to dissuade banks from using the discount window excessively. This was true from 2003 to 2020, but since 2020 the Fed has set the discount rate at the top of the federal funds range. (The effective FFR is typically closer to the middle of the range, which is 0.25 percentage points wide.) It is now more concerned with banks not using the discount window enough than using it excessively, and it has adopted a "no questions asked" policy toward borrowers.
- **The Fed uses reserve requirements to influence monetary policy and prudential regulation.** Reserve requirements were permanently set to zero in 2020. Once the Fed moved to an abundant reserve framework, reserve requirements were unnecessary. Even before that, the Fed did not change reserve requirements as a monetary policy tool because it was considered too blunt a tool.[16]
- **The Fed conducts monetary policy by targeting the money supply.** The Fed targets interest rates rather than the money supply. It cannot control both simultaneously. The Fed considers money demand to be too erratic for the money supply to be a useful policy target.
- **Banks need to join the Federal Reserve System to use the discount window or hold master accounts at the Fed.** Since 1980, all insured depository institutions can borrow from the discount window and hold master accounts.
- **The dollar is backed by gold.** The Fed does not own gold—the New York Fed safeguards the gold holdings of central banks, governments, and official international organizations that choose to store their gold there. The federal government's gold holdings are small compared to the currency in circulation or the federal debt. The federal government abandoned a true gold standard in 1933.
- **The government prints money to finance the deficit (or) the government cannot default on the debt because the Fed will monetize deficits.** Legally, the Treasury cannot issue money—only the Fed can—and the Fed cannot purchase newly issued debt directly from the federal government. The federal debt is financed by the government issuing Treasury securities and selling them to private investors. The Fed is a large investor in Treasury securities (acquired on the secondary market) and is currently reducing its holdings. In a scenario where private investors became unwilling to finance future deficits, the Fed could choose to be the buyer of last resort of federal debt on the open market, but it might choose not to because it would be inconsistent with its statutory mandate of price stability. The government cannot compel the Fed to purchase debt.

This report discusses these issues in more detail.

As mentioned above, the FOMC sets monetary policy. FOMC meetings are regularly scheduled every six weeks, but the chair sometimes calls unscheduled meetings. After each of these meetings, the FOMC releases a statement that announces any changes to monetary policy, the rationale for the current monetary stance, and the future outlook.

In normal economic conditions, the Fed's primary instrument for setting monetary policy is the FFR, the overnight interest rate in the federal funds market, a private market where banks lend to each other. The Fed sets a target range for the FFR that is 0.25 percentage points wide and uses its tools to keep the actual FFR within that range. When the Fed wants to stimulate the economy, it makes policy more expansionary by reducing interest rates. When it wants to make policy more contractionary or tighter, it raises rates. In principle, there is a neutral interest rate that is neither expansionary not contractionary, although it is difficult to estimate what the neutral rate is in

[16] Their removal is related to the shift to the "abundant reserves" monetary framework discussed below. See Federal Reserve, "Federal Reserve Actions to Support the Flow of Credit to Households and Businesses," press release, March 15, 2020, https://www.federalreserve.gov/newsevents/pressreleases/monetary20200315b.htm. According to the Fed, "Currently, the Board has no plans to re-impose reserve requirements. However, the Board may adjust reserve requirement ratios in the future if conditions warrant." Federal Reserve, "Reserves Administration Frequently Asked Questions," https://www.frbservices.org/resources/central-bank/faq/reserve-account-admin-app.html.

practice, and it seems to change over time.[17] The Fed aims to make monetary policy expansionary, contractionary, or neutral based on how employment and inflation are performing compared to its statutory goals: Expansionary policy can boost employment but risks spurring inflation, while contractionary policy can constrain inflation but risks decreasing employment, as explained below.

Changes in the FFR target lead to changes in interest rates throughout the economy, although these changes are mostly less than one-to-one. Changes in interest rates affect overall economic activity by changing the demand for interest-sensitive spending (goods and services that are bought on credit). The main categories of interest-sensitive spending are business physical capital investment (e.g., plant and equipment), consumer durables (e.g., automobiles, appliances), and residential investment (mainly, new housing construction). All else equal, higher interest rates reduce interest-sensitive spending, and lower interest rates increase interest-sensitive spending.

Interest rates also influence the demand for exports and imports by affecting the value of the dollar. All else equal, higher interest rates increase net foreign capital inflows as U.S. assets become more attractive relative to foreign assets. To purchase U.S. assets, foreigners must first purchase U.S. dollars, pushing up the value of the dollar. When the value of the dollar rises, the price of foreign imports declines relative to U.S. import-competing goods, and U.S. exports become more expensive relative to foreign goods. As a result, net exports (exports less imports) decrease. When interest rates fall, all of these factors work in reverse, and net exports increase, all else equal.

Business investment, consumer durables, residential investment, and net exports are all components of gross domestic product (GDP). Thus, if expansionary monetary policy causes interest-sensitive spending to rise, it increases GDP in the short run. This increases employment as more workers are hired to meet increased demand for goods and services. An increase in spending also puts upward pressure on inflation.[18] Contractionary monetary policy has the opposite effect on GDP, employment, and inflation. Most economists believe that although monetary policy can permanently change the inflation rate, it cannot permanently change the level or growth rate of GDP, because long-run GDP is determined by the economy's productive capacity (the size of the labor force, capital stock, and so on). If monetary policy pushes demand above what the economy can produce, then inflation should eventually rise to restore equilibrium. When setting monetary policy, the Fed must take into account the lags between a change in policy and economic conditions so that rate changes can be made preemptively.

The Fed generally tries to avoid policy surprises, and FOMC members regularly communicate their views on the future direction of monetary policy to the public.[19] The Fed describes its monetary policy plans as "data dependent," meaning plans would be altered if actual employment or inflation deviate from its forecast. Data is volatile, however, and true data dependence in policy setting would lead to sudden shifts in policy. In practice, the Fed likes to avoid surprises as much as possible, so large-scale shifts in course are relatively infrequent.

Besides monetary policy, fiscal policy (statutory changes in spending and revenue levels) is the other primary tool for the federal government to affect macroeconomic conditions.[20] In addition

[17] See CRS Insight IN11056, *Low Interest Rates, Part 2: Implications for the Federal Reserve*, by Marc Labonte.

[18] The Fed targets interest rates instead of money supply growth because the relationship between money supply growth and inflation is unpredictable. The current target range is reported at Federal Reserve, "Policy Tools," https://www.federalreserve.gov/monetarypolicy/openmarket.htm.

[19] The Fed imposes "blackout" rules to prevent officials from publicly discussing potentially market-moving topics close to FOMC meetings.

[20] See CRS In Focus IF11253, *Introduction to U.S. Economy: Fiscal Policy*, by Lida R. Weinstock.

to affecting employment and inflation, both monetary policy and fiscal policy affect interest rates but in opposite directions. Expansionary monetary policy reduces interest rates, whereas expansionary fiscal policy increases the supply of debt that must be financed by private investors, thereby increasing interest rates, all else equal. As a practical matter, monetary policy can be adjusted far more frequently and finely than fiscal policy can. Whereas Congress is responding to numerous policy considerations when setting fiscal policy, monetary policy is trying to achieve only two goals—price stability and maximum employment. For these reasons, economists view monetary policy as the primary macroeconomic stabilization tool. Given the Fed's independence, fiscal and monetary policy can potentially work together (e.g., both expansionary) or at odds with each other (e.g., one is expansionary and the other is contractionary) at any given time.

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

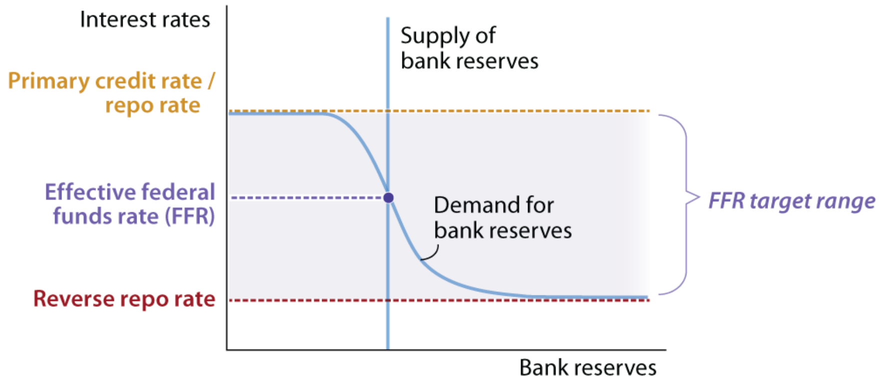
The Post-Financial Crisis Monetary Policy Framework

Following the 2007-2009 financial crisis, the Fed changed how it conducted monetary policy. The Fed now maintains the FFR target primarily by setting the interest rate it pays banks on reserves held at the Fed (interest on reserves, or IOR) and by using reverse repos to drain liquidity from the financial system. It received statutory authority to pay interest on reserves in 2008.[21] In 2014, the Fed created a standing reverse repo facility to help put a floor under the FFR. Financial market participants earn interest by lending excess cash to the Fed at the reverse repo facility. Unlike the FFR, the Fed sets the IOR and the rate offered at its reverse repo facility directly. The IOR and repo rate anchor the FFR, as shown in **Figure 3**, because banks will generally deploy their surplus reserves to earn whichever rate is most attractive.[22] Currently, the top of the target range is set equal to the rate for borrowing from the Fed through the discount window (called the primary credit rate) and the Standing Repo Facility (SRF), and the bottom of the range is equal to the rate for lending to the Fed through the overnight reverse repo facility. This keeps the FFR within the target range. The IOR is currently set slightly below the top of the range.

[21] Repos are economically equivalent to short-term collateralized loans. Depending on whether viewed from the perspective of the borrower or lender, they are referred to as repos or reverse repos, respectively. For a primer on repos, see CRS In Focus IF11383, *Repurchase Agreements (Repos): A Primer*, by Marc Labonte.

[22] The IOR might be expected to set a floor on the FFR, but in practice the actual FFR has typically been slightly lower than the IOR. This discrepancy has been ascribed to the fact that some participants in the federal funds market—such as Fannie Mae, Freddie Mac, and the Federal Home Loan Banks—do not earn interest on reserves held at the Fed. See Gara Afonso et al., "Who's Lending in the Fed Funds Market," Federal Reserve Bank of New York, December 2, 2013, http://libertystreeteconomics.newyorkfed.org/2013/12/whos-lending-in-the-fed-funds-market.html#.VDWOgxYXOmo.

Figure 3. Illustration of Supply and Demand for Bank Reserves and the Federal Funds Rate



Source: CRS.

Note: See text for details.

Before the crisis, monetary policy was conducted differently. The Fed did not have authority to pay interest on bank reserves until 2008, so it could not target the FFR by setting the IOR.[23] Instead, the Fed directly intervened in the federal funds market through open market operations that added or removed reserves from the federal funds market. Open market operations could be conducted by buying or selling Treasury securities but were typically conducted through repos. The Fed's counterparties in open market operations (called primary dealers) are major participants in the Treasury market. When the Fed buys Treasury securities or lends in the repo market, it increases bank reserves, putting downward pressure on the FFR. Selling securities or borrowing in the repo market (which the Fed calls a reverse repo) has the opposite effect. The Fed did not create any expectation that repo market participants could rely on it to provide needed liquidity or remove excess liquidity from the market. (As noted above, the Fed still purchases Treasury securities and uses repos and reverse repos, but it no longer does so to target the FFR.)

Before the crisis, the Fed could target the FFR through direct intervention in the federal funds market because reserves were scarce—banks held only enough reserves to slightly exceed the reserve requirements set by the Fed. Now, banks hold trillions of dollars of reserves despite the fact that the Fed eliminated reserve requirements in 2020. The overall level of reserves is the result of Fed actions—primarily quantitative easing (QE), discussed below—that have increased the Fed's balance sheet and are not a choice of banks. Thus, it is represented by a vertical line in **Figure 3**. After the Fed ended QE in 2014, it decided to maintain abundant reserves (sometimes referred to as the *abundant reserves* framework) instead of fully shrinking its balance sheet and returning to its pre-crisis *scarce reserves* monetary framework. With reserves so abundant, adding or removing reserves could not raise the FFR above zero in the absence of IOR and a standing (i.e., on-demand) reverse repo facility.

During the 2007-2009 financial crisis and the COVID-19 pandemic, the Fed made very large amounts of repo funding available on an ad hoc basis to ensure that markets stayed liquid. In 2021, the Fed added the SRF—where primary dealers and banks could borrow repo financing from the Fed on demand—to make it easier to keep the FFR from exceeding its target as it shrinks its balance sheet. But the facility also shifted the assurance that Fed repo funding would

[23] The authority (12 U.S.C. §461(b)) for the Fed to pay interest on reserves was originally granted in the Financial Services Regulatory Relief Act of 2006, beginning in 2011. The start date was made immediate in the Emergency Economic Stabilization Act of 2008 (P.L. 110-343).

be available in times of need from an ad hoc to a permanent basis. The repo and reverse repo facilities, which fundamentally altered the functioning of a private lending market (by creating a permanent Fed backstop in the market), were created using existing authority without congressional approval or notice-and-comment rulemaking.

Interest Rates After a High Inflation Episode

In response to the historically large and sudden contraction in economic activity caused by the onset of the COVID-19 pandemic, the Fed provided monetary stimulus that was matched in magnitude only by the stimulus provided during the 2007-2009 financial crisis. This stimulus included nontraditional actions such as reducing the FFR to the zero lower bound, purchasing trillions of dollars of securities, and providing billions of dollars of credit to the financial sector, as discussed below.

This stimulus safeguarded against the risk that the contraction in economic activity would persist. In hindsight, economic activity rebounded relatively quickly, and high inflation turned out to be the larger concern. After decades of low inflation, inflation has been above the Fed's 2% target since March 2021. PCE inflation (measured as the 12-month change) peaked above 7% in June 2022, its highest level in decades. Several factors contributed to the rise in inflation. On the supply side, these included supply chain disruptions and high commodity prices following the Russian invasion of Ukraine. On the demand side, these included strong consumer demand, in part because of the fiscal and monetary stimulus put in place during the pandemic.[24]

Mainstream economists view the ability to effectively reduce inflation to lay primarily with the Fed. In the words of Fed Chair Jerome Powell, "The first lesson [from the history of inflation] is that central banks can and should take responsibility for delivering low and stable inflation."[25] Despite higher inflation since 2021, the Fed left this stimulus in place until March 2022, because Fed leadership assumed that the initial increase in inflation in 2021 was transitory and due to the ongoing threat of the pandemic. Decades of sustained low—at times, undesirably low—inflation may have led the Fed to underestimate the threat of high inflation. By the time stimulus began to be withdrawn, inflation had become high, widespread, and deeply embedded.

Beginning in March 2022, the primary focus of monetary policy shifted to reducing high inflation. The Fed raised rates repeatedly following each FOMC meeting from March 2022 to July 2023—by as much as 0.75 percentage points following some meetings—and began a gradual reduction of the balance sheet in June 2022.[26] By July 2023, rates were at their highest levels since 2007. This led to fears of a recession or "hard landing."[27]

Instead, the Fed seems to have achieved its hoped for "soft landing," where inflation falls without triggering a recession. Since its peak, inflation has rapidly declined and employment growth has moderated (perhaps to a more sustainable growth rate) without contracting.[28] The combination of

[24] See CRS Report R47273, *Inflation in the U.S. Economy: Causes and Policy Options*, by Marc Labonte and Lida R. Weinstock.

[25] Chair Jerome H. Powell, "Monetary Policy and Price Stability," speech, August 26, 2022, https://www.federalreserve.gov/newsevents/speech/powell20220826a.htm.

[26] The Fed can mitigate inflationary pressures by raising interest rates or reducing the size of its balance sheet, and different combinations of the two will yield the same economic outcomes. In practice, it has based its inflation reduction strategy on raising interest rates and has not based its balance sheet reduction plans on the inflation rate.

[27] Francois de Soyres and Zina Saijid, *Lessons from Past Monetary Easing Cycles*, Federal Reserve, May 31, 2024, https://www.federalreserve.gov/econres/notes/feds-notes/lessons-from-past-monetary-easing-cycles-20240531.html.

[28] GDP growth was strong in the second and third quarters of 2024, however, so it is unclear whether the slowdown in employment growth is demand-driven.

improving supply chains, lower energy prices, and tighter monetary policy brought inflation down much closer to the Fed's 2% target, but it has remained slightly above the target to date.

A few low monthly inflation readings gave the Fed confidence that inflation was heading back to 2%, and the Fed reduced rates three times between September and December 2024. The Fed chose to reduce rates before inflation reached 2%—the 12-month headline PCE was nearly 2% in September, but core PCE was still above 2.5% and has not fallen in recent months[29]—for two primary reasons. First, because of the lags between a change in monetary policy and its effects on the economy, the Fed wants to adjust monetary policy in anticipation of the economy's projected path, which it believed was heading toward stable inflation and a softer labor market. (Although unemployment is still relatively low, it has risen gradually since 2023—to 4.1% in December 2024—and job growth has been slower beginning in the second quarter of 2024.) Second, the Fed deemed that the risks to employment and inflation were in better balance and so wanted to move monetary policy to a more neutral stance, where it was neither stimulating nor contracting the economy.

At the January 2025 FOMC meeting, the Fed left the FFR unchanged. Since September, inflation has not fallen, which may have given the Fed pause. At the FOMC press conference, Chair Powell explained that the Fed left rates unchanged because "[w]ith our policy stance significantly less restrictive than it had been, and the economy remaining strong, we do not need to be in a hurry to adjust our policy stance."[30] Neither the FOMC nor Chair Powell indicated whether they expected that rates would be cut at near future meetings. Nevertheless, the latest forecast (from December 2024) of the appropriate path of interest rates by FOMC participants had most participants favoring additional rate cuts in 2025 and 2026 that would bring policy to what participants believe to be a more neutral stance.[31] The Fed aims to have the actual FFR close to the neutral rate (discussed above) at times like this when it views the risks to employment and inflation to be roughly in balance. The Fed and most economists believe that the FFR is still above the neutral rate—in other words, monetary policy is still contractionary—even after the 2024 rate cuts.[32]

According to the January 2025 FOMC statement, the FOMC "judges that the risks to achieving its employment and inflation goals are roughly in balance. The economic outlook is uncertain, and the [FOMC] is attentive to the risks to both sides of its dual mandate."[33] Given that inflation was high from 2021 to 2023, there is a risk that reducing rates before inflation has fallen all the way to 2% will undermine the Fed's goal of restoring price stability. Some economists have expressed concerns that the "last mile" of inflation reduction will be the hardest.[34] The Fed

[29] *Headline inflation* refers to the overall inflation rate. Core inflation is headline inflation excluding food and energy. The Fed and other economists often focus on short-term movements in core rather than headline inflation to glean the underlying inflationary trend by stripping out two of the more volatile elements of inflation.

[30] Federal Reserve, "Transcript of Chair Powell's Opening Statement," January 29, 2025, https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20250129.pdf.

[31] Federal Reserve, "Summary of Economic Projections," December 18, 2024, https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20241218.pdf.

[32] For example, the median projection of FOMC participants is for the FFR to be 3% in the long run. Federal Reserve, "Summary of Economic Projections."

[33] Federal Reserve, "Federal Reserve Issues FOMC Statement," press release, January 29, 2025, https://www.federalreserve.gov/newsevents/pressreleases/monetary20250129a.htm.

[34] See Steven B. Kamin and John M. Roberts, "How Will the Interaction of Wages and Prices Play Out in the Last Mile of Disinflation?," American Enterprise Institute, July 2024, https://www.aei.org/wp-content/uploads/2024/07/Kamin-Roberts-Prices-and-Wages-WP.pdf; and Randal J. Verbrugge, "Inflation's Last Half Mile: Higher for Longer?," Federal Reserve Bank of Cleveland, May 30, 2024, https://www.clevelandfed.org/publications/economic-commentary/2024/ec-202409-inflations-last-half-mile.

always has the option to raise rates if inflation does not continue falling, but it might be reluctant to do so, because it tries to avoid frequent and sudden reversals in policy. On the other hand, the risk to the employment part of the Fed's mandate has grown, which calls for lower rates.

Also working against the Fed's more stimulative policy since September 2024 is the fact that, in the last quarter of 2024, long-term rates rose while short-term rates fell. Much private consumption and investment spending is more sensitive to long-term rates than short-terms rates. This development underscores the limits of the Fed's influence over economic activity.

If the economy were to experience unexpected price shocks, such as a rise in energy prices, it could complicate the return to price stability. Generally, price shocks are equally likely to reduce or increase prices. However, economists expect one potential change on the horizon to increase prices: President Trump's proposed tariffs, if implemented, are expected to increase the prices of affected goods.[35] (The magnitude of their impact on overall inflation would depend on at what rate they are levied and how broadly they apply.) Price shocks lead to temporary changes in inflation unless they destabilize inflation expectations. If an external factor were to cause inflation to rise, the Fed might be hesitant to reverse its present course and start raising interest rates to neutralize it, as was the case in 2021 when it decided not to respond to what it viewed as a "transitory" increase in inflation. There would then be the risk of a prolonged period of higher inflation again, especially if recent high inflation has made future price shocks have longer lasting effects on inflation.

Policy issues for Congress going forward could include the following:

- Can the Fed successfully restore price stability with lower rates? Would the Fed be able to neutralize the effects of proposed new tariffs on inflation? If unemployment rises further before inflation has returned to 2%, should the Fed prioritize reducing inflation or unemployment?
- Are high long-term rates undermining the Fed's attempt to provide monetary stimulus through low short-term rates? What can Congress do for U.S. businesses and households that are negatively affected by higher interest rates? Would actions to assist them make it harder to achieve price stability?
- Could price stability be restored more quickly if monetary tightening is accompanied by tighter fiscal policy? Would tighter fiscal policy lead to higher unemployment or help reduce long-term interest rates, complementing lower short-term rates?

For more information, see CRS Insight IN12427, *Why Is the Federal Reserve Reducing Interest Rates?*, by Marc Labonte.

Normalizing the Fed's Balance Sheet

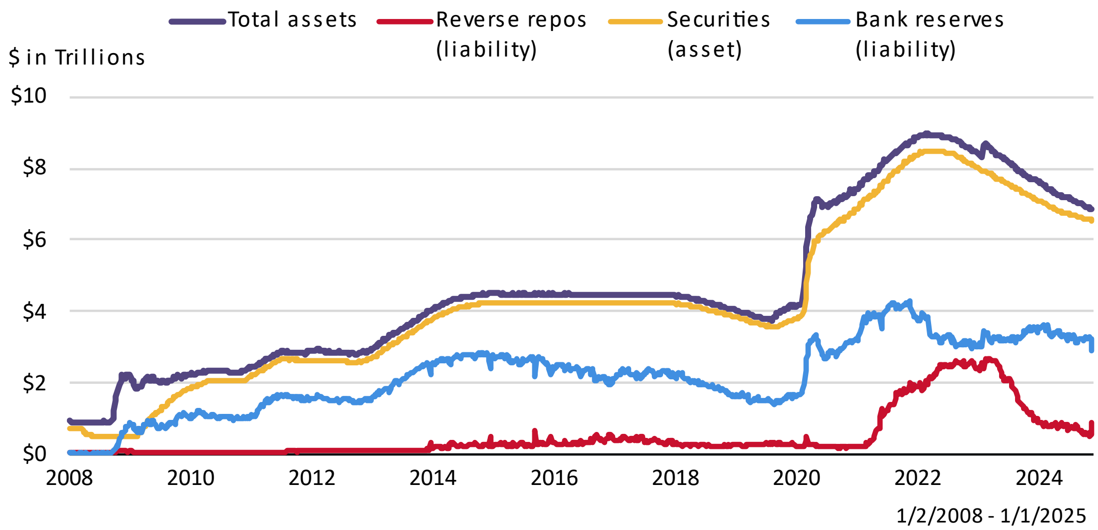
The Fed's balance sheet can be described in standard accounting terms. Like any company, the Fed holds assets on its balance sheet that are equally matched by the sum of its liabilities and capital. The Fed's assets are primarily Treasury securities and mortgage-backed securities (MBS) acquired through open market operations.[36] Its assets also include discount window loans, loans

[35] A change in policy that resulted in a sharp decline in net migration could also affect inflation, but its effect is more ambiguous because it affects supply and demand.

[36] Except in emergencies, the Fed is allowed to purchase only a limited range of securities, including securities issued or guaranteed by the government or government agencies (12 U.S.C. §355). The Fed considers MBS guaranteed by government-sponsored enterprises to qualify. Congress has placed no limit on the amounts of eligible securities it may purchase.

and assets held by its other emergency facilities, and repos lent to the private sector through its SRF.[37] Its liabilities are primarily currency, reverse repos borrowed from the private sector, bank reserves held in master accounts at the Fed, and balances that Treasury holds at the Fed.[38] When the Fed purchases assets or makes loans, its balance sheet gets larger, which is matched predominantly by growth in two of its liabilities—reverse repos and bank reserves, as seen in **Figure 4**.

Figure 4. Selected Assets and Liabilities on Fed's Balance Sheet, 2008-2024



Source: Federal Reserve.

Twice in its history—during the 2007-2009 financial crisis and the COVID-19 pandemic—the Fed has lowered the FFR target range to 0%-0.25% (called the zero lower bound) in response to unusually severe economic disruptions. Because the zero lower bound prevented the Fed from providing as much conventional stimulus as desired to mitigate these crises, it turned to unconventional monetary policy tools in an effort to reduce longer-term interest rates. Under this policy (popularly called quantitative easing, or QE), it purchased trillions of dollars of primarily Treasury securities and MBS in an effort to directly lower their yield. As a result, the Fed's balance sheet grew significantly in three rounds of purchases from 2008 to 2014 and then again when it made purchases from 2020 to 2022. The Fed's balance sheet expanded from $4.7 trillion in March 2020 to $7 trillion in May 2020 to a high of almost $9 trillion in May 2022.[39] Before the Fed started reducing its balance sheet, nearly $5.8 trillion of its assets were held in Treasury securities and $2.7 trillion in MBS. At that time, about $3.4 trillion of its liabilities were held in

[37] Repos outstanding have been zero since June 2020 because, in normal financial conditions, repo market participants can borrow at lower cost privately than from the Fed. In periods of financial instability, the Fed can ease overall liquidity conditions by making large amounts of repos available. For example, during the pandemic, the Fed made $1 trillion in overnight repos available at auction every day and made an additional $500 billion in longer-term repos available at least once a week.

[38] Reserves are assets held as liquid balances (in cash or at the Fed), as opposed to funds invested in loans or securities.

[39] The balance sheet also increases when the Fed provides credit to banks and other financial market participants, which are assets on the balance sheet. In both crises, this played a significant role in the initial increase in the balance sheet, but credit outstanding fell quickly as financial conditions normalized. For more details on the balance sheet, see Federal Reserve, "Credit and Liquidity Programs and the Balance Sheet: Recent Balance Sheet Trends," https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm.

bank reserves and $2.2 trillion in reverse repos. At its peak, the balance sheet was around 10 times larger than it was before 2009.

The goals of QE were to reduce long-term interest rates and provide additional liquidity to the financial system. QE reduced long-term interest rates by driving down yields on the securities the Fed was purchasing, which led to lower interest rates throughout the economy.[40] (Following the financial crisis, the Fed concentrated its purchases in long-term securities. Following the pandemic, the Fed purchased securities across the maturity spectrum so that the disproportionate effect on long-term rates would be diminished.) The reduction in yields on MBS translated to lower mortgage rates, stimulating housing demand. QE increased liquidity by increasing bank reserves.

As part of its efforts to tighten monetary policy, the Fed began to taper its asset purchases (i.e., it reduced the growth rate of the balance sheet) in November 2021, ended its purchases (i.e., it kept the size of the balance sheet steady) in March 2022, and began to reduce the size of its balance sheet in June 2022. This reduction is passive and occurs by the Fed not fully replacing maturing assets with new asset purchases—the Fed has no plans to sell securities currently. Beginning in June 2024, the Fed has reduced the speed at which the balance sheet is shrinking and is currently allowing up to $25 billion in Treasury securities and $35 billion in MBS to roll off every month. In months where the amounts of securities rolling off have exceeded the caps, the Fed has purchased assets to replace the excess amounts. In months where fewer securities have rolled off than the cap amount, the balance sheet has shrunk by less than $60 billion.[41] At the end of 2024, the size of the balance sheet was about $6.9 trillion, with $4.3 trillion in Treasury securities and $2.2 trillion in MBS. On the liability side, the reduction thus far has mainly occurred through a reduction in reverse repos, which fell to $0.9 trillion at the end of 2024.

In statements in January and May 2022, the Fed laid out its long-term goals for the balance sheet.[42] In the long run, the Fed intends to hold primarily Treasury securities, eventually eliminating its MBS holdings. It intends to permanently maintain a large balance sheet, which is consistent with its "ample reserves" framework for monetary policy,[43] and "intends to slow and then stop the decline in the size of the balance sheet when reserve balances are somewhat above the level it judges to be consistent with ample reserves."[44] It has not yet indicated what it expects that level to be.[45] A New York Fed official expects the balance sheet to be larger than it was before the COVID-19 pandemic ($4.2 trillion) when the wind-down is complete.[46] When

[40] When the price of a debt security rises, its effective yield falls. New debt can then be sold at the prevailing lower yield.

[41] Because the MBS held by the Fed are backed mostly by mortgages with interest rates that are lower than current market rates, borrowers have not been repaying or refinancing those mortgages at a high pace, causing MBS roll offs to be lower than the cap in most months. The Fed reported roll offs relative to the caps in Federal Reserve Bank of New York, *Open Market Operations During 2022*, April 2023, https://www.newyorkfed.org/medialibrary/media/markets/omo/omo2022-pdf. For technical reasons, the actual reduction in the balance sheet does not match these caps from month to month. For an explanation, see Federal Reserve Bank of New York, "The 'How and When' of the Fed's Balance Sheet Runoff," September 8, 2022, https://medium.com/new-york-fed/the-how-and-when-of-the-feds-balance-sheet-runoff-3c37787fa948.

[42] Federal Reserve, "FOMC Communications Related to Policy Normalization," https://www.federalreserve.gov/monetarypolicy/policy-normalization.htm.

[43] See the section above entitled "The Post-Financial Crisis Monetary Policy Framework."

[44] Federal Reserve, "FOMC Communications Related to Policy Normalization."

[45] The New York Fed has created a new metric for reserve demand elasticity to attempt to monitor when reserves are becoming scarcer. Available at https://www.newyorkfed.org/research/reserve-demand-elasticity/#interactive.

[46] Julie Remache, "Balance Sheet Basics, Progress, and Future State," speech, February 7, 2024, https://www.newyorkfed.org/newsevents/speeches/2024/rem240207.

complete, this is sometimes referred to as an *ample reserves framework*, as opposed to the pre-crisis *scarce reserves framework* or post-crisis *abundant reserves framework*.

Policy issues for Congress going forward could include the following:

- Did the Fed's large purchases of Treasury securities compromise its independence by making it more susceptible to subordinating monetary policy in order to provide low-cost financing of the federal debt? Do the Fed's holdings (and its effect on Treasury yields) make policies that increase the federal debt more attractive to Congress and the Administration?
- Does QE contribute to asset bubbles that have negative implications for financial stability and wealth inequality? If so, do these costs outweigh the benefits of providing more stimulus during crises?
- How soon will the Fed stop shrinking its balance sheet? What is the best way to avoid disruptions to Treasury and repo markets, as occurred in the fall of 2019, which caused the Fed to reverse course and start increasing the balance sheet again?
- To avoid such disruptions, will the Fed err on the side of leaving the balance sheet unnecessarily large? Will the Fed be able to avoid having a permanently outsized presence in repo markets through heavy use of its SRF?
- Did the Fed's MBS purchases contribute to making house prices rise out of reach for first-time buyers? How can the Fed disengage from the MBS market without disrupting mortgage markets at a time when mortgage rates have risen sharply? Should Congress consider limiting the types of securities, such as MBS and agency debt, that the Fed is authorized to purchase?
- Is it possible or desirable for Congress to limit the Fed's future use of QE?

For more information, see CRS In Focus IF12147, *The Fed's Balance Sheet and Quantitative Tightening*, by Marc Labonte.

Losses on the Fed's Balance Sheet

The Fed earns income on its loans, repos, and securities holdings, which, along with fees it charges, are used to finance its expenses. Its expenses include operating expenses and the interest paid on bank reserves and reverse repos, two of its main liabilities. The difference between income and expenses is called net income, which is similar to profits. Net income is used first to pay statutorily required dividends to shareholders, with the remainder transferred to the Treasury (called remittances), where they are added to the federal government's general revenues.[47] Because remittances cannot be used to finance additional federal spending, they effectively make the budget deficit and federal debt smaller than they otherwise would be.

The Fed's balance sheet consists mostly of longer-term assets and very short-term liabilities. Typically, longer-term assets have higher yields than short-term liabilities do, so net income is positive. However, since September 2022, the Fed's interest expenses have exceeded its interest income, causing net income to be negative and remittances to temporarily fall to near zero.[48] Net income has been negative because interest rates rose sharply in 2022. As a result, the interest rate

---

[47] If the Fed's surplus were below its statutory cap, net income could also be used to increase it, but this scenario is unlikely.

[48] Net income and remittances for each of the 12 Federal Reserve banks are calculated individually. Because not all 12 banks had negative net income throughout 2023 and 2024, a small balance was remitted to Treasury.

the Fed pays on bank reserves and reverse repos became higher than the yield on securities it acquired when interest rates were much lower. As discussed above, the Fed acquired large holdings of low-yielding securities through QE during the pandemic.[49] Interest expenses rose from $5.7 billion in 2021 to $102.4 billion in 2022 to $281.1 billion in 2023 to $214.5 billion in the first three quarters of 2024.

Remittances had not been zero since 1934.[50] In 2023 and 2024, they were effectively zero. The yield on the Fed's assets will eventually exceed the yield on its liabilities again—either because the Fed will reduce interest rates on its liabilities enough or because low-yielding assets on the Fed's balance sheet will eventually mature and be replaced by higher yielding assets.[51] At that point, net income will become positive again, but projections suggest that it may take a few years.[52] The Congressional Budget Office projects that remittances will be less than $10 billion annually until FY2028.[53]

Although Fed losses have reduced federal revenues since September 2022, cumulative federal revenues over time have still been larger than they would have been if the Fed had not expanded its balance sheet, which led to unusually large remittances from 2009 to 2022 (see **Figure 5**). Beginning in 2009, its net income and remittances increased significantly as a result of its balance sheet growth caused by QE and low short-term interest rates on its liabilities. Between 2009 and 2022, annual remittances were between $47 billion and $117 billion each year. Before 2009, the largest annual remittance ever was $35 billion. Moreover, this considers only the direct effect of QE on the federal budget. If QE returned the economy to full employment faster, that also had a positive indirect effect on the federal budget.

[49] For example, at the end of 2024, 85% of its MBS holdings had coupon rates of 3% or lower. Data available at https://www.newyorkfed.org/data-and-statistics/data-visualization/system-open-market-account-portfolio.

[50] In some years, remittances were statutorily required. In years with no statutory requirement, remittances were the result of positive net income. Federal Reserve, *109th Annual Report of the Board of Governors of the Federal Reserve System*, 2022, Table G.10, https://www.federalreserve.gov/publications/files/2022-annual-report.pdf.

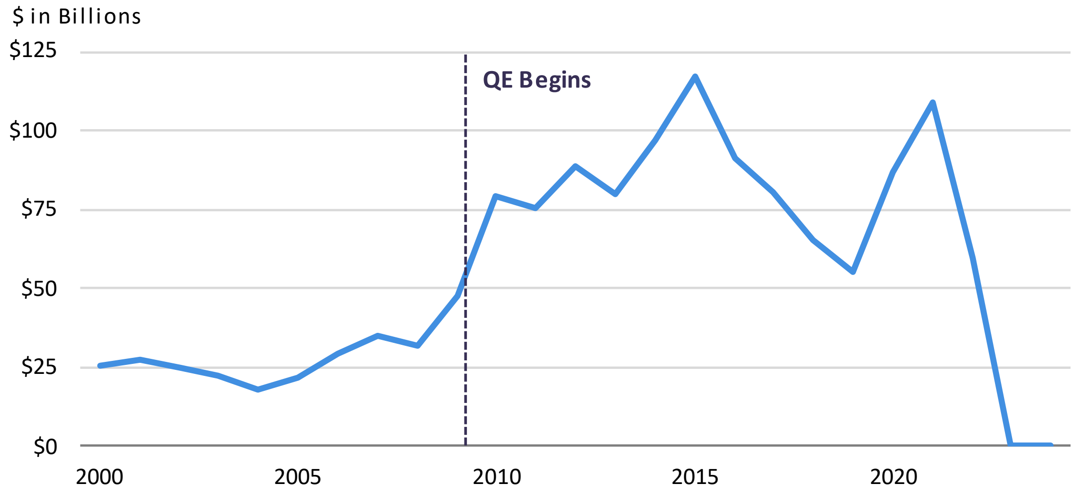
[51] The Fed does not mark its balance sheet holdings to market, so unrealized losses on assets do not reduce net income or remittances. So long as the Fed continues to hold its securities to maturity, as planned, the Fed will not realize any losses through sales of these securities, and the chance that these securities will suffer losses upon maturity is negligible.

[52] In the third quarter of 2024, the yield on Treasury securities and MBS held by the Fed was below 2.25%, still lower than the prevailing interest rate on reserves and overnight repo rate. See Federal Reserve, *Combined Quarterly Financial Report*, September 30, 2024, http://www.federalreserve.gov/aboutthefed/files/quarterly-report-20241122.pdf.

[53] Data table available at https://www.cbo.gov/system/files/2025-01/51138-2025-01-Revenue-Projections.xlsx.

Figure 5. Fed Remittances to Treasury

2000-2024



Sources: Federal Reserve, *Annual Report—2023*, Table G.10, https://www.federalreserve.gov/publications/2023-ar-statistical-tables.htm; Federal Reserve, "Federal Reserve Board Announces Preliminary Financial Information for the Federal Reserve Banks' Income and Expenses in 2023," press release, January 12, 2024, https://www.federalreserve.gov/newsevents/pressreleases/other20240112a.htm; Federal Reserve, "Factors Affecting Reserve Balances—H.4.1," January 2, 2025, https://www.federalreserve.gov/releases/h41/20250102.

Partly because of the statutory limit on its surplus, the Fed holds very little capital relative to its liabilities, and losses since September 2022 have been an order of magnitude larger than its entire surplus. But unlike a private company, the Fed does not reduce its capital, become insolvent, or require a capital infusion to maintain solvency in response to losses. Instead, under its accounting conventions, it registers the losses as a deferred asset. At the end of 2024, the deferred asset exceeded $200 billion. Positive net income in future years would be directed to eliminating this deferred asset before remittances to Treasury resume.

Private companies hold capital to prevent losses from causing insolvency. But unlike with a private company, the Fed's recent losses—which exceed its capital—have not affected its ability to honor its liabilities, and its creditors cannot compel it to declare bankruptcy. The Fed is not a profit-maximizing institution—its remittances are a byproduct of monetary policy, not the metric to judge the success of monetary policy. Losses are a sign not of mismanagement but that its interest-bearing liabilities had higher yields than its interest-bearing assets did. Losses since 2022 have not reduced the confidence of market participants and do not seem to have affected the Fed's political independence. If the Fed based monetary policy on concerns about its profits and losses, this would detract from achieving its statutory mandate of maximum employment and stable prices.

Policy issues for Congress going forward could include the following:

- Should the Fed reconsider how it conducts QE to reduce the possibility that future episodes of balance sheet expansion would ultimately result in losses (e.g., by purchasing short-term instead of long-term securities)?

- To reduce the possibility of future losses, should the Fed revert to the scarce reserves operating framework in place before 2008 so that it does not need to pay interest on reserves and reverse repos in order to target interest rates?[54]
- Should the Fed use conventional accounting standards that would increase transparency surrounding its financial condition but would require it to accumulate more capital (through reduced remittances) to absorb potential losses? Or would conventional accounting standards be inappropriate given its unique financial status?
- Does the Fed's temporary shift from a profit-making entity to a loss-making entity change the rationale for its financing of the CFPB's operations?
- Should Congress raise the statutory limit on the Fed's surplus to increase the Fed's capital stock if it is concerned about losses? Alternatively, should Congress eliminate the surplus entirely to avoid further use of the surplus as a "pay for" for unrelated policy changes?[55]

Mandate Reform and Monetary Policy Strategy

Until 2012, the Fed did not have an inflation target, meaning it did not provide public guidance on how it interpreted its statutory mandate numerically. Since 2012, the FOMC has explained how it interprets its mandate in its *Statement on Longer-Run Goals*. It defines *stable prices* as 2% inflation, measured as the annual percentage change in the PCE price index. It does not set a corresponding maximum employment target, because, in the Fed's view, maximum employment "is not directly measurable and changes over time owing largely to nonmonetary factors that affect the structure and dynamics of the labor market." The Fed aims to meet its target on average over time, offsetting periods of inflation below 2% with periods above 2%.

After a review, the FOMC announced revisions to its *Statement on Longer-Run Goals and Monetary Policy Strategy* on August 27, 2020.[56] The revised statement provided more detail on how monetary policy would react to the problem that inflation had fallen below its 2% target for most of the period from the financial crisis until its issuance. It emphasized changes in strategy to make this less likely in the future, including advocating periods of above-target inflation to follow periods of below-target inflation and—assuming inflation is low—pledging to lower rates when unemployment is high but not to raise rates when unemployment is low. The latter approach was unorthodox but compatible with the tendency for inflation to be low regardless of whether unemployment was low or high from the financial crisis through 2020.

---

[54] If the Fed reverted to its pre-financial crisis framework for conducting monetary policy, average profits would be lower, but losses would also be less likely.

[55] Previous efforts by Congress to prohibit the use of the surplus as a budgetary pay-for have failed because current Congresses cannot tie the hands of future Congresses. For example, a scorekeeping rule adopted in H.Con.Res. 290 in the 106th Congress prohibited the scoring of such Fed surplus transfers as a budgetary offset in the Senate. Although this rule was not repealed, surplus transfers have since been used as offsets.

[56] A description of the review is at https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications.htm. The 2020 statement is at https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications-statement-on-longer-run-goals-monetary-policy-strategy.htm. For more information, see CRS Insight IN11499, *The Federal Reserve's Revised Monetary Policy Strategy Statement*, by Marc Labonte.

The Fed has announced a new review in 2025 to update its *Statement on Longer-Run Goals and Monetary Policy Strategy* and to consider any changes to its "policy communication tools."[57] The review will not reconsider the 2% inflation target. Since 2021, the inflation-unemployment relationship seemed to strengthen again, as very low unemployment coincided with very high inflation. Because inflation has been above target instead of below target since 2021, the FOMC might consider whether the 2020 revisions are no longer relevant and have instead become counterproductive.[58] For example, with its emphasis on not raising rates when unemployment is high, the 2020 revisions may have contributed to the Fed's decision to keep the FFR at zero until inflation had reached nearly 7%.[59]

The Fed's dual mandate provides the Fed with discretion on how to interpret the terms *maximum employment* and *stable prices* and how to achieve those goals. It contains no repercussions if the goals are missed—as they are whenever the economy enters a recession, as it did briefly in 2020, or when inflation is above target, as it has been since 2021. In practice, the mandate may be better thought of as a forward-looking guide (i.e., how monetary policy should react when economic outcomes differ from mandated goals) than a backward-looking benchmark (i.e., what are the consequences for the Fed when it misses its mandated goals). Unexpected events such as the pandemic and the war in Ukraine temporarily cause inflation and employment to deviate from the mandate, but the mandate guides how the Fed should respond when it does while providing the Fed maximum discretion to decide how to respond.

There is a long-standing debate among economists about what type of central bank mandate and what monetary policy strategies lead to the best economic outcomes.[60] The Fed had been successful at delivering low and stable inflation over the past four decades—until 2021. Whether its policies or external forces are to blame for intermittent periods where maximum employment was not achieved during that time is debatable, but the Fed does not seem better or worse than its international peers at avoiding recessions. Some commentators believe that a sole goal of price stability would be more effective than the dual mandate at achieving low inflation and macroeconomic stability on the grounds that the Fed has no influence over employment in the long run.[61] Others believe that full employment should get more weight and price stability less.[62] The Fed under the past few chairs has argued—and many economists agree—that the economy has been well served by a dual mandate that balances both parts of the mandate evenly. In any

[57] Federal Reserve, "Federal Reserve Announces Additional Information About the Periodic Review of Its Monetary Policy Strategy, Tools, and Communications," press release, November 22, 2024, https://www.federalreserve.gov/newsevents/pressreleases/monetary20241122a.htm.

[58] One study estimated that as a result of the strategy shift, the Fed delayed raising the FFR from zero by two quarters and that inflation was 0.3 percentage points higher than it would otherwise be at its peak. Andrew Hodge et al., "U.S. and Euro Area Monetary and Fiscal Interactions During the Pandemic: A Structural Analysis," International Monetary Fund, November 11, 2022, https://www.imf.org/en/Publications/WP/Issues/2022/11/11/U-S-524029; Gauti B. Eggertsson and Don Kohn, "The Inflation Surge of the 2020s: The Role of Monetary Policy," Brookings Institution, August 2023, https://www.brookings.edu/wp-content/uploads/2023/07/WP87-Eggertsson-Kohn_7.25.pdf.

[59] Anna Cieslak et al., "Did I Make Myself Clear? The Fed and the Market in the Post-2020 Framework Period," working paper, June 10, 2024, https://www.brookings.edu/wp-content/uploads/2024/05/Cieslak-McMahon-Pang-_conference-draft.pdf. See also Brookings Institution, "An Agenda for the Federal Reserve's Review of Its Monetary Policy Framework," June 14, 2024, https://www.brookings.edu/events/an-agenda-for-the-federal-reserves-review-of-monetary-policy-framework/.

[60] See CRS Report R41656, *Changing the Federal Reserve's Mandate: An Economic Analysis*, by Marc Labonte.

[61] Thomas Hogan and Alexander William Salter, "The Fed Needs a Single Mandate," *The Hill*, July 30, 2022, https://thehill.com/opinion/finance/3580777-the-fed-needs-a-single-mandate/.

[62] Fed Up, "A Full-Employment Economy, A Federal Reserve That Works for Working People," April 2021, https://fedupcampaign.org/wp-content/uploads/2021/06/A-Full-Employment-Economy-A-Fed-that-Works-for-Working-People.pdf.

case, international comparisons suggest that central banks are likely to react to changes in both unemployment and inflation regardless of whether they have single or dual mandates.

Independent of their mandate types, most central banks have adopted some sort of numerical inflation target or goal, although there is little consistency in how central banks react when actual inflation deviates from the target. Some economists believe that the Fed's 2% target is too low, while others believe it is too high. Some economists believe that a nominal GDP target or some form of price level targeting would work better than an inflation target. (A pure price level target, unlike the Fed's inflation target, would require a period of deflation to reverse price rises that occur during periods of high inflation.) Those targets would be more complicated, which could reduce public comprehension of Fed policy and the likelihood that they would be met. Other economists argue that discretionary monetary policy should be replaced or reduced by a focus on monetary policy rules[63]—that is, mathematical formulas that prescribe how interest rates should be set based on a limited number of economic variables, such as the output gap and inflation. Rules reduce arbitrary decisionmaking by removing emotion and instincts from policymaking, but opponents of these types of proposals believe that the need to nimbly react to unexpected shocks such as the financial crisis or the pandemic makes such proposals irrelevant or counterproductive in real-world policymaking. If these types of changes are desirable, the Fed could pursue them internally, or Congress could impose them through legislation.

Policy issues for Congress going forward could include the following:

- Should the current mandate be maintained because it has generally resulted in effective policymaking under diverse conditions? Would a change to the mandate strengthen or weaken congressional oversight?
- Has the recent period of high inflation strengthened the case for a single mandate of price stability? Should the 2025 strategy review reverse the 2020 changes to the Fed's monetary policy strategy in light of recent high inflation? Does public displeasure with high inflation suggest that the Fed should put greater weight on maintaining price stability, even if it comes at the expense of maximum employment?
- Conversely, does the Fed overweight its price stability mandate compared to its maximum employment mandate? If so, what changes could more appropriately balance the two?
- Should financial stability be added to the Fed's statutory mandate, or is the Fed already sufficiently focused on financial stability?
- Is the 2% inflation target the best way to achieve the Fed's price stability mandate? Should the 2025 strategy review have reconsidered whether 2% is the best target? Should the Fed clarify how much inflation can deviate from its target and still be acceptable (e.g., 1-3%)? Would another measure—such as a nominal GDP target, a price level target, or a policy rule—be more effective, or would those measures needlessly complicate monetary policymaking and reduce public understanding of the Fed's intentions?

---

[63] Sometimes monetary policy rules are called Taylor rules after the creator of an early rule, economist John Taylor. See CRS In Focus IF10207, *Monetary Policy and the Taylor Rule*, by Marc Labonte.

Bank Regulation

The Fed regulates bank holding companies (BHCs) and thrift holding companies—parent companies that own (almost) all large and most small depositories—to try to ensure that they do not pose safety and soundness risks to their depositories and for other regulatory requirements.[64] The Fed is also the primary prudential regulator of state-chartered banks that have elected to become members of the Federal Reserve System and most types of U.S. operations of foreign banking organizations. The Fed approves applications from banks under its jurisdiction, including merger applications and applications to form new banks.

The Fed has rulemaking, supervisory, and enforcement authorities to carry out its regulatory responsibilities, and many policy issues involve recent and forthcoming actions using those authorities. Often in concert with the other banking regulators,[65] it promulgates rules and guidance that apply to banks and examines depository firms under its supervision to ensure that those rules are being followed and that those firms are conducting business prudently. The Fed's supervisory authority includes consumer protection compliance for banks under its jurisdiction that have $10 billion or less in assets.[66]

The Fed has also historically had a focus on maintaining financial stability, which the Dodd-Frank Act made the primary responsibility of the Financial Stability Oversight Council (FSOC), with certain new duties assigned to the Fed.[67] For example, under the Dodd-Frank Act the Fed regulates large BHCs and systemically important financial institutions for systemic risk, as discussed in the next section. The Fed coordinates policy with other regulators on FSOC and through the Federal Financial Institutions Examination Council. The Fed also participates in intergovernmental fora, such as the Financial Stability Board and the Basel Committee on Banking Supervision, alongside other U.S. agencies.

Regulatory relief is expected to be on the near-term agenda for three reasons. First, President Trump and the committees of jurisdiction have identified reducing the regulatory burden on banks through changes to regulation or supervision as a priority in the 119th Congress.[68] Second, the

---

[64] The Fed was assigned regulatory responsibility for thrift holding companies as a result of the Dodd-Frank Act, which eliminated the Office of Thrift Supervision as the regulator of thrifts. Currently, the Fed regulates five thrift holding companies that own insurance subsidiaries. For more information on BHCs, see CRS Report R48291, *Bank Holding Companies: Background and Issues for Congress*, by Marc Labonte.

[65] The federal banking regulatory system is charter based. Federally chartered (national) commercial banks are regulated by the Office of the Comptroller of the Currency (OCC), and state-chartered commercial banks that do not join the Federal Reserve System are regulated by the Federal Deposit Insurance Corporation (FDIC). National banks are required to become members of the Fed, and state banks have the option of becoming members, but the Fed is the primary regulator of only the latter. A BHC is regulated by the Fed at the holding company level, and its banking subsidiaries can be regulated by the Fed, FDIC, or OCC, depending on the subsidiary's charter. For more information, see CRS Report R44918, *Who Regulates Whom? An Overview of the U.S. Financial Regulatory Framework*, by Marc Labonte.

[66] The Dodd-Frank Act transferred the Fed's authority to promulgate consumer protection rules to the CFPB, but the Fed retained supervisory responsibilities for banks under its jurisdiction that have $10 billion or less in assets. Although the CFPB was created as a bureau of the Fed, the Fed has no authority to select CFPB's leadership or employees or to set or modify CFPB policy. The CFPB's budget is financed by a transfer from the Fed. The amount is set in statute and cannot be altered by the Fed. For more information, see CRS In Focus IF10031, *Introduction to Financial Services: The Consumer Financial Protection Bureau (CFPB)*, by Cheryl R. Cooper and David H. Carpenter.

[67] FSOC is a council of regulators, including the Fed, headed by the Treasury Secretary.

[68] See White House, "Regulatory Freeze Pending Review," January 20, 2025, https://www.whitehouse.gov/presidential-actions/2025/01/regulatory-freeze-pending-review/; U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, "Scott Announces Banking Committee Priorities for the 119th Congress," press release, (continued...)

bank regulators are in the midst of a statutorily mandated periodic review to "identify outdated or otherwise unnecessary regulatory requirements" with the goal of reducing regulatory burden.[69] This review will likely culminate in rulemaking to provide targeted regulatory relief across a number of bank regulations. Third, the Supreme Court's 2024 *Loper* decision overturning the Chevron doctrine ended judicial deference to "reasonable agency interpretations of an ambiguous statute." This decision may lead to more—and possibly more successful—legal challenges by banks to regulations.[70]

An early example of how *Loper* may change the Fed's approach to regulation were two developments at the end of 2024. First, the Fed announced that it planned to submit future annual large bank stress tests—which have been conducted in various forms without rulemaking since 2009—to the rulemaking process. Second, bank trade groups filed a lawsuit to require the Fed to submit documents related to future stress tests to the rulemaking process and vacate recent stress testing documents that were not subject to the rulemaking process.[71]

There are a number of ongoing regulatory issues of interest to Congress covered in the following sections. There are also joint regulatory initiatives with other federal financial regulators that are beyond the scope of this report.

Large Bank Issues

The 2007-2009 financial crisis highlighted the problem of "too big to fail" (TBTF) financial institutions—the concept that the failure of large financial firms could trigger financial instability, which in several cases prompted extraordinary federal assistance to prevent their failure. Title I of the 2010 Dodd-Frank Act (P.L. 111-203) aimed to increase financial stability and end TBTF by creating an enhanced prudential regulatory (EPR) regime administered by the Fed that applies to large banks and to nonbank financial institutions designated by FSOC as systemically important financial institutions. Since enactment, the number of designated nonbank firms has ranged from four to none today.[72]

Under this regime, the Fed is required to apply a number of safety and soundness requirements to large banks that are more stringent than those applied to smaller banks and are intended to mitigate systemic risk:

January 15, 2025, https://www.banking.senate.gov/newsroom/majority/scott-announces-banking-committee-priorities-for-the-119th-congress; and U.S. Congress, House Committee on Financial Services, "Authorization and Oversight Plan of the Committee on Financial Services," https://docs.house.gov/meetings/BA/BA00/20250122/117834/HMTG-119-BA00-20250122-SD004.pdf.

[69] Section 2222 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (12 U.S.C. §3311) requires the bank regulators to conduct this review every 10 years. The review culminates with a report to Congress, likely to be released in 2027. The regulators maintain a website tracking this process at https://egrpra.ffiec.gov/.

[70] See CRS Report R48320, *Loper Bright Enterprises v. Raimondo and the Future of Agency Interpretations of Law*, by Benjamin M. Barczewski.

[71] Federal Reserve, "Due to Evolving Legal Landscape and Changes in the Framework of Administrative Law, Federal Reserve Board Will Soon Seek Public Comment on Significant Changes to Improve Transparency of Bank Stress Tests and Reduce Volatility of Resulting Capital Requirements," press release, December 23, 2024, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20241223a.htm; *Bank Policy Institute v. Board of Governors of the Federal Reserve System*, Case: 2:24-cv-04300-EAS-CMV, Doc #: 1, https://bpi.com/wp-content/uploads/2024/12/BPI-OHChamber-OHBankers-ABA-Chamber-Stress-Testing-Complaint-2024.12.24.pdf.

[72] See CRS Insight IN10982, *After Prudential, Are There Any Systemically Important Nonbanks?*, by Marc Labonte and Baird Webel.

- **Stress tests and capital planning** are designed to ensure that banks hold enough capital to survive a crisis. Stress tests are conducted by both the Fed and the banks.
- **Resolution plans ("living wills")** provide plans to safely wind down failing banks.
- **Liquidity requirements** are designed to ensure that banks are sufficiently liquid if they lose access to funding markets.
- **Counterparty limits** restrict banks' exposure to counterparty default.
- **Risk management** standards require publicly traded companies to have risk committees on their boards and banks to have chief risk officers.
- **Financial stability** requirements provide for regulatory interventions that can be taken only if a bank poses a threat to financial stability.
- **Capital requirements** require large banks to hold more capital than other banks do to potentially absorb unforeseen losses. These include the **supplementary leverage ratio**. Banks that have been designated as global systemically important banks (G-SIBs) by the Financial Stability Board must also meet a **G-SIB capital surcharge**. Stress test results determine how much capital large banks must hold through the **stress capital buffer**.

The Dodd-Frank Act automatically subjected all BHCs and foreign banks operating in the United States with more than $50 billion in assets to EPR. In 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act (P.L. 115-174) created a more tiered and tailored EPR regime for banks. It eliminated most EPR requirements for banks with assets between $50 billion and $100 billion, with the exception of risk management requirements. G-SIBs and banks that have more than $250 billion in assets automatically remain subject to all EPR requirements, as modified. Section 401 of P.L. 115-174 gives the Fed discretion to apply most individual EPR provisions to banks with between $100 billion and $250 billion in assets on a case-by-case basis only if the provisions would promote financial stability or the institution's safety and soundness.[73] Under the Fed's 2019 implementing rules, large banks are placed into four categories based on their size and complexity, and progressively more stringent requirements are imposed on them.[74] The rule also applied EPR to foreign banks with large U.S. operations and large savings and loan

---

[73] Members of Congress debated whether P.L. 115-174 and the Fed's implementing rule in 2019 contributed to SVB's failure. Because SVB was under $250 billion in assets when it failed, it was never subject to EPR requirements applying to Category III banks. SVB had over $100 billion in assets in 2020, but the Fed phased in compliance with those requirements slowly when a bank crossed the threshold, so SVB was never subject to EPR requirements applying to Category IV banks before it failed. Even if it had been subject to these rules, it is questionable whether most of them would have addressed the specific causes of SVB's failure. For more information, see the section entitled "Role of EPR in 2023 Bank Failures" in CRS Report R47876, *Enhanced Prudential Regulation of Large Banks*, by Marc Labonte.

[74] Federal Reserve, "Federal Reserve Board Finalizes Rules That Tailor Its Regulations for Domestic and Foreign Banks to More Closely Match Their Risk Profiles," press release, October 10, 2019, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191010a.htm; Federal Reserve, "Federal Reserve Board Issues Final Rule Modifying the Annual Assessment Fees for Its Supervision and Regulation of Large Financial Companies," press release, November 19, 2020, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20201119a.htm; Federal Reserve, FDIC, and OCC, "Agencies Issue Final Rule to Strengthen Resilience of Large Banks," press release, October 20, 2020, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20201020b.htm; Federal Reserve and FDIC, "Agencies Finalize Changes to Resolution Plan Requirements; Keeps Requirements for Largest Firms and Reduces Requirements for Smaller Firms," press release, October 28, 2019, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191028b.htm.

(thrift) holding companies that are not predominantly engaged in insurance or nonfinancial activities.[75]

Currently, the Fed has several proposed rules outstanding, in some cases issued jointly with other bank regulators, that would modify large bank regulatory requirements:

- In 2018, the Fed and the Office of the Comptroller of the Currency (OCC) proposed a rule to incorporate the G-SIB surcharge into the enhanced supplementary leverage ratio for G-SIBs.[76]
- The federal banking regulators issued a joint proposal to implement the "Basel III Endgame" in July 2023 for banks with $100 billion or more in assets, discussed in more detail below.
- On the same day, in a separate proposal, the Fed proposed changing how the G-SIB surcharge is calculated.[77]
- In August 2023, the banking regulators proposed subjecting all banks with $100 billion or more in assets to long-term debt requirements and clean holding company requirements to facilitate orderly liquidation in the event of a bank's failure.[78]
- In December 2024, the Fed announced that it intends to issue a proposal in 2025 to increase the transparency and reduce the volatility of the Fed-run stress tests. The proposal would make the annual stress test scenarios and models subject to notice and comment.[79]

Policy issues for Congress going forward could include the following:

- Has the Dodd-Frank Act, as amended, effectively mitigated TBTF? Or do large banks pose more systemic risk now than they did at the time of enactment? If so, are complementary or alternative policy approaches needed to address TBTF? How much additional regulation for large banks is consistent with a "level playing field" when TBTF is a factor?
- Did the 2019 changes to EPR better tailor EPR to match the risks posed by large banks? Or did these changes allow additional systemic and taxpayer risk that outweigh the benefit of reduced regulatory burden, especially if the benefits have

[75] For a summary of the rule, see Federal Reserve, "Requirements for Domestic and Foreign Banking Organizations," https://www.federalreserve.gov/aboutthefed/boardmeetings/files/tailoring-rule-visual-20191010.pdf.

[76] OCC and Federal Reserve, "Regulatory Capital Rules," 83 *Federal Register* 17317, April 19, 2018, https://www.govinfo.gov/content/pkg/FR-2018-04-19/pdf/2018-08066.pdf.

[77] The proposal was published in the *Federal Register* in September 2023. Federal Reserve, "Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15)," 88 *Federal Register* 60385, September 1, 2023, https://www.govinfo.gov/content/pkg/FR-2023-09-01/pdf/2023-16896.pdf.

[78] OCC, Federal Reserve, and FDIC, "Long-Term Debt Requirements for Large Bank Holding Companies, Certain Intermediate Holding Companies of Foreign Banking Organizations, and Large Insured Depository Institutions," 88 *Federal Register* 64524, September 19, 2023, https://www.govinfo.gov/content/pkg/FR-2023-09-19/pdf/2023-19265.pdf. The proposal also makes technical changes to the TLAC rule. For a comparison, see Davis Polk, "Comparison of the Long-Term Debt Proposal to the Existing TLAC Rule," September 5, 2023, https://www.davispolk.com/sites/default/files/2023-09/comparison-of-LTD-proposal-and-TLAC-rule.pdf.

[79] Federal Reserve, "Due to Evolving Legal Landscape." One day later, bank trade groups filed a lawsuit to ensure "bank capital requirements are established in a transparent manner, with public input, in accordance with the Administrative Procedure Act ('APA')." See *Bank Policy Institute v. Board of Governors of the Federal Reserve System*. In the 118th Congress, H.R. 8337 would have required the Fed to promulgate rules on stress tests.

accrued mainly to the affected banks? Should Congress revisit the scope or applicability of EPR—such as the asset threshold for mandatory application of EPR and the exemption of large banks without holding companies—following the large bank failures of 2023?

- Should annual supervisory stress tests be subject to the rulemaking process? Is there sufficient transparency surrounding these stress tests? Or would greater transparency be akin to giving banks the answers to the exam in advance?

For more information, including details of the proposed rules discussed above, see CRS In Focus IF12755, *"Too Big to Fail" Financial Institutions: Policy Issues*, by Marc Labonte; and CRS Report R47876, *Enhanced Prudential Regulation of Large Banks*, by Marc Labonte.

Basel III Endgame[80]

Setting bank capital requirements is an iterative process. Requirements have repeatedly been tweaked over the decades as problems emerged or policy priorities changed. For example, in 2013 U.S. regulators began implementing "Basel III," a revamp of the capital framework aimed at addressing many of the issues believed to precipitate the global financial crisis that was negotiated by the Basel Committee on Banking Supervision (BCBS), an international standard-setting body. A set of BCBS recommendations from 2017 fill in some of the more technical details of Basel III and are sometimes colloquially referred to as the *Basel III Endgame*.[81]

On July 27, 2023, the federal banking regulators jointly issued a proposed rule that would revise large bank capital requirements.[82] In addition to implementing the Basel III Endgame, the proposal would implement (1) some of the recommendations that Fed Vice Chair Michael Barr proposed in a previous holistic capital review and (2) certain changes responding to issues that arose when three large banks failed in 2023. The proposal would apply to banks with over $100 billion in assets—a threshold exceeded by all three failed banks. According to the proposal, its purpose is to improve the consistency of capital requirements across banks, better match capital requirements to risk, reduce their complexity, and improve transparency of banks' financial conditions for supervisors and the public.

In the United States, Category I and II banks (under the Fed's 2019 rule implementing P.L. 115-174, as discussed above) are currently required to calculate their requirements using two methods: a standardized approach applicable to all banks and a specialized *advanced approach* that allows the banks to model many of their own risks. Although internal models can potentially be "gamed" (i.e., designed in a way to allow a bank to hold less capital rather than accurately measure risk), they can also model risk more sophisticatedly and be more tailored to a bank's unique risk profile. Following the Basel III Endgame, the proposed rule would reduce the use of internal models through a new second standardized approach for advanced approach banks called the *expanded risk-based approach*. Other banks with over $100 billion in assets would be required to calculate risk-weighted assets under two approaches for the first time. Despite the regulators' intentions to reduce complexity, many within the industry have criticized this dual approach to capital requirements as unduly burdensome.

---

[80] This section draws from other CRS products coauthored with Andrew Scott.

[81] BCBS, *Basel III: Finalising Post-Crisis Reforms*, December 2017, https://www.bis.org/bcbs/publ/d424.pdf.

[82] OCC, Federal Reserve, and FDIC, "Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking Organizations with Significant Trading Activity," 88 *Federal Register* 64028, September 18, 2023, https://www.govinfo.gov/content/pkg/FR-2023-09-18/pdf/2023-19200.pdf. A summary, fact sheet, and overview are available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230727a.htm.

The proposal would also require banks with over $100 billion in assets to include unrealized capital gains and losses on available-for-sale debt securities in their capital levels. Unrealized capital losses were one of the primary causes of SVB's failure.[83] The proposal would also extend two capital requirements—the supplementary leverage ratio and the countercyclical capital buffer—to all banks with over $100 billion in assets.

One criticism of the proposal is that it is not capital neutral but, rather, would require subjected banks to hold more capital. Although the proposal does not raise required capital ratios, the regulators estimate that its effect on risk-weighted assets would increase the average binding common equity capital level that large banks are required to hold by 16%. Note that (1) this estimate is an average, and the effects on any particular bank would differ, and (2) this is an estimate based on past data—the actual effect would depend on future actions by the banks, including how they responded to the rule. The proposal would have a larger capital effect on trading activities than on lending, and it is estimated to have the largest effect on G-SIBs.

In September 2024, Fed Vice Chair Barr announced that he intended to repropose the Endgame proposal and the G-SIB surcharge proposal in a way that would reduce the additional capital that large banks would be required to hold compared to the original proposals.[84] To date, the Fed, FDIC, and OCC have reportedly not reached a consensus on a reproposed rule, however.

Policy issues for Congress going forward could include the following:

- Should the regulatory treatment of uninsured deposits or unrealized losses on securities be changed in light of the 2023 bank failures? Limited to large banks and available-for-sale securities, would the Basel Endgame proposal go far enough or too far in addressing unrealized losses?
- Is it appropriate to change capital standards in such a way that large banks are required to hold more capital overall, or do large banks already hold sufficient capital? How would the proposal affect their competitiveness with small banks and nonbank financial firms? Would the proposal make the financial system safer or needlessly restrict credit?
- Have domestic deviations from Basel standards led to inappropriate "gold plating" of capital requirements? Does the requirement that large banks comply with two sets of capital standards add unduly burdensome complexity, or does it ensure a level playing field with smaller banks?
- Is the proposal appropriately tailored by exempting banks with under $100 billion in assets? Or should it be further tailored to treat, say, banks near the $100 billion threshold differently from G-SIBs?
- Would the proposed changes to the risk weights have negative effects on specific sectors or activities, such as mortgage lending, activities with fee-based income, trading activities, and tax equity renewable energy projects?
- Does the Fed's leading role in crafting international standards for bank regulation and the financial system—and its domestic implementation of those standards through the rulemaking process—improperly bypass Congress's policymaking authority? Or is Congress's ability to overturn the Fed's regulatory actions on an expedited basis through the Congressional Review Act sufficient to safeguard congressional prerogatives? Should Congress have more input on Basel standards

---

[83] See CRS Insight IN12232, *Banks' Unrealized Losses, Part 2: Comparing to SVB*, by Marc Labonte.

[84] Vice Chair for Supervision Michael S. Barr, "The Next Steps on Capital," speech, September 10, 2024, https://www.federalreserve.gov/newsevents/speech/barr20240910a.htm.

(and other internationally negotiated bank standards), or would that disadvantage the United States in negotiations?[85] Should the bank regulators have publicly provided more analysis independent of BCBS's to justify the proposal?

For more information, see CRS Report R47855, *Bank Capital Requirements: Basel III Endgame*, by Marc Labonte and Andrew P. Scott.

Fed Supervision

The failure of SVB brought attention to the Fed's supervisory practices. A post-mortem report by the Fed attributes SVB's failure to poorly managed interest rate risk, liquidity risk (in its case, an overreliance on uninsured deposits), and concentration risk (a lack of diversification in its customers and portfolio). Its risk management capacity did not keep pace with its rapid growth.[86] Although the responsibility for these shortcomings is SVB's, these are all core issues that banks are regulated and supervised for.[87] Aaron Klein, a senior fellow at the Brookings Institution, noted "at least four classic red flags of the bank's conduct that should have sent the alarm bells ringing."[88] The Fed's SVB report details how "SVB's foundational problems were widespread and well-known, yet core issues were not resolved, and stronger oversight was not put in place." When SVB failed, it had 31 outstanding Matters Requiring Attention (MRAs) and Matters Requiring Immediate Attention (MRIAs) issued by Fed examiners.[89] Nonetheless, SVB did not receive a deficient rating in any area until 2022. The deficient rating should have triggered a formal enforcement action but did not.[90]

Congress has oversight responsibilities for Fed supervision. Congress has largely deferred to the Fed on its supervisory practices in the past, reflecting its status as a highly independent, self-funded agency. Oversight is also hindered by the fact that most supervisory information from the bank regulators, such as a bank's rating, is highly confidential, because bank-specific information could be market-moving. Yet even aggregate, anonymized information is highly limited.[91]

The Fed reports data at least annually on overall supervisory ratings and actions. In 2024, the Fed reported that two-thirds of large institutions it regulates were rated less-than-satisfactory in at least one of three categories, up from one-half in 2021. For community and regional banks, 6% were rated less-than-satisfactory overall. The Fed reported 1,009 outstanding MRAs (including MRIAs) for large banks (5.7 per bank on average), 306 for regional banks (2.9 per bank), and

---

[85] In the 118th Congress, H.R. 4790 passed the House. It would have required the Fed (and other financial regulators) to report on their interactions with international organizations, such as the BCBS, and to provide reporting, testimony, and analysis to Congress before issuing a major final rule based on recommendations from an international organization.

[86] Federal Reserve, "Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank," April 2023, https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf.

[87] See the section entitled "Silicon Valley Bank (SVB) Failure" in CRS Report R47377, *Federal Reserve: Policy Issues in the 118th Congress*, by Marc Labonte.

[88] Aaron Klein, "SVB's Collapse Exposes the Fed's Massive Failure to See the Bank's Warning Signs," Brookings Institution, March 16, 2023, https://www.brookings.edu/opinions/svbs-collapse-exposes-the-feds-massive-failure-to-see-the-banks-warning-signs/.

[89] Key supervisory findings, referred to as MRAs, are required to be included in all supervisory communication documents, and the examiner is required to discuss any outstanding MRAs in the supervisory report. Crucially, the examiner is required to specify a time frame for the bank to complete corrective action. Some findings are more critical and urgent to address and are considered MRIAs.

[90] Federal Reserve, "Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank."

[91] In the 118th Congress, S. 2190 and H.R. 3556 would have required the Fed and other bank regulators to provide more supervisory information to the public or Congress, among other provisions. See CRS In Focus IF12454, *Bank Failures and Congressional Oversight*, by Marc Labonte.

1,407 for community banks in 2024 (0.4 per bank), with the largest category of MRAs in management/governance/controls or information technology and operational risk. Since 2021, the number of outstanding MRA has increased rapidly for all categories of domestic banks.[92] If an MRA is serious or is not addressed by the bank in a timely fashion, the bank's rating could be downgraded, or an enforcement action could be taken against it.

The Fed does not report how quickly these MRAs are resolved or how frequently they lead to enforcement actions.[93] Based on the limited information provided by the Fed, it is difficult to know what this means for bank regulatory compliance and Fed supervisory vigilance. Does the large and growing number of less-than-satisfactory ratings and outstanding MRAs imply that banks are rife with reckless behavior, endangering financial stability? If they are, why has the Fed not taken stronger actions to ensure the safety and soundness of the financial system? Given that there are thousands of findings outstanding each year, why does the Fed report that the "banking system remains sound and resilient overall"? Or are banks being unreasonably burdened with trivial, rote, and nebulous compliance issues that pose no real risk to safety and soundness? Less-than-satisfactory ratings or outstanding findings are not concentrated in areas directly linked to financial risk, such as capital, credit risk, and liquidity. Greg Baer, head of the Bank Policy Institute, argues that MRAs are treated as binding enforcement actions when they should not be and are justified on safety and soundness grounds when many involve issues that do not truly threaten a bank's safety and soundness.[94] (It should be noted that, since 2021, supervisors are limited by regulation to issue "criticism" based only on violations of law, threats to safety and soundness, or consumer harm.[95])

Although some concluded from the SVB episode that Fed supervision is too "light touch," banks sometimes complain that supervision is too heavy handed.[96] They complain that regulation is too complex, leading to compliance costs that are too high, credit allocation distortions, and innocent mistakes that trigger adverse supervisory actions. Acting Comptroller of the Currency Michael Hsu has warned against supervision becoming a "check the box" exercise where there are too many boxes and all are given equal weight.[97]

Under Title 12, Section 4806, of the *U.S. Code*, the banking regulators are required to provide banks with an appeals process for supervisory findings consisting of agency officials who were not involved in the decisions being appealed. The banking regulators are also required to have ombudsmen to act as liaisons between banks and the agencies and ensure safeguards in the

---

[92] Federal Reserve, "Supervision and Regulation Report," November 2024, https://www.federalreserve.gov/publications/2024-november-supervision-and-regulation-report.htm.

[93] A recent Government Accountability Office (GAO) report provided previously unavailable data on bank supervisory actions. GAO reports that between 2018 and 2023, the Fed opened about 1,400 more MRAs or MRIAs than it closed and issued 272 informal enforcement actions and 322 formal enforcement actions. GAO found "long time frames between the identification of concerns and the issuance of enforcement actions." GAO, *Bank Supervision: Federal Reserve and FDIC Should Address Weaknesses in Their Process for Escalating Supervisory Concerns*, GAO-25-106771, November 2024, Appendix III, https://www.gao.gov/assets/gao-25-106771.pdf.

[94] Testimony of Greg Baer before U.S. Congress, Senate Banking, Housing, and Urban Affairs Committee, *Hearing on Banking Agencies Regulation and Supervision of the Industry*, 116th Cong., April 30, 2019.

[95] 12 C.F.R. Part 262, Appendix A.

[96] Greg Baer, "The Bank Examination Problem, and How to Fix It," Bank Policy Institute, July 17, 2024, https://bpi.com/the-bank-examination-problem-and-how-to-fix-it/.

[97] Acting Comptroller of the Currency Michael Hsu, "Evolving Bank Supervision," remarks before the Joint European Banking Authority and European Central Bank International Conference, September 3, 2024, https://occ.gov/news-issuances/speeches/2024/pub-speech-2024-95.pdf.

complaint process. Congress has debated whether to make statutory changes to strengthen the appeals process for banks.[98]

Policy issues for Congress going forward could include the following:

- In light of supervisory shortcomings identified by the Fed in SVB's failure, should Congress defer to the Fed on strengthening supervisory practices or take a more active role? Does Congress have sufficient aggregate information about bank supervision to support its oversight role?
- Should Congress broaden statutory prompt corrective action standards beyond capital adequacy to strengthen the role of poor supervisory ratings or other early warning signs of bank failures?[99]
- Is the existing supervisory appeals process sufficiently independent and free from fear or retaliation? Would strengthening banks' rights in the appeal process undermine the goals of regulation?

For more information, see CRS Report R46648, *Bank Supervision by Federal Regulators: Overview and Policy Issues*, by David W. Perkins.

Climate Change

The Fed increased its focus on the financial and economic risks posed by climate change in recent years, although that trend may now reverse. 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. However, the Fed withdrew from the network in January 2025. In 2021, the Fed created two internal committees related to climate risk.

Building on existing regulatory practices,[100] in October 2023, the Fed and other banking regulators issued joint final guidance that provides "a high-level framework for the safe and sound management of exposures to climate-related financial risks" for banks with over $100 billion in assets. According to the regulators, "The final principles neither prohibit nor discourage large financial institutions from providing banking services to customers of any specific class or type."[101]

In 2023, the six largest banks participated in a Fed-led pilot "climate scenario analysis" to "help identify potential risks and promote risk management practices."[102] This exercise does not have

---

[98] See, for example, H.R. 8337 in the 118th Congress.

[99] 12 U.S.C. §1831o. Currently, if a bank receives a less-than-satisfactory rating for asset quality, management, earnings, or liquidity, then the bank's PCA rating can be downgraded by one category. FDIC, *Formal and Informal Enforcement Actions Manual*, ch. 5, 2022, https://www.fdic.gov/regulations/examinations/enforcement-actions/ch-05.pdf.

[100] In the past, the Fed has stated that climate risk is covered by its existing supervisory guidance on underwriting, which requires bank management to take into account all relevant risks. Further, it stated that its guidance on managing risk from extreme weather events is well equipped for managing an increase in extreme weather events caused by climate change. See Jerome Powell, letter to the Hon. Brian Schatz, April 18, 2019, https://www.schatz.senate.gov/imo/media/doc/Chair%20Powell%20to%20Sen.%20Schatz%204.18.19.pdf.

[101] Federal Reserve, FDIC, and OCC, "Agencies Issue Principles for Climate-Related Financial Risk Management for Large Financial Institutions," joint press release, October 24, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231024b.htm. In the 118th Congress, the House Financial Services Committee reported H.J.Res. 125, which would have overturned this guidance under the Congressional Review Act.

[102] Federal Reserve, "Federal Reserve Board Provides Additional Details on How Its Pilot Climate Scenario Analysis Exercise Will Be Conducted and the Information on Risk Management Practices That Will Be Gathered over the (continued...)

any implications for capital requirements or supervision and therefore is not considered by the Fed to be a stress test. Members of Congress have debated whether large banks should be subject to "climate stress tests." Current stress tests are meant to evaluate whether large banks would remain well capitalized in a scenario of extreme economic and financial downturn over a three-year period. Annual capital requirements for large banks are based in part on stress test results. Under a true climate stress test, capital requirements would be based in part on a bank's exposure to climate risk. One challenge to climate stress testing is that time horizons are much longer than in current stress tests and subject to significant uncertainty.

The BCBS has proposed international standards on climate risk disclosure for banks.[103] At a hearing, Fed Vice Chair Barr described negotiations on those standards as ongoing and said that the Fed and other banking regulators have not yet decided whether to adopt them.[104] As discussed above, any Basel standards could be implemented domestically only through U.S. rulemaking by the federal bank regulators.

The Fed has not been legislatively tasked to focus on climate change, but it has argued that climate change has implications for economic and financial stability. For example, a 2021 report from FSOC, of which the Fed is a member, identified climate change as an emerging and increasing threat to financial stability and made a number of recommendations for agency actions, which include the actions the Fed has taken to date.[105]

Critics argue that due to the gradual nature of climate change, it is unlikely to pose systemic risk, because financial markets will have time to adjust and reprice assets and credit to reflect higher disaster risk.[106] They are also concerned that climate risk policies will unfairly steer credit away from fossil fuel and other energy intensive industries. They argue that climate change policy is best addressed by Congress and that a focus on climate change distracts the Fed from its mission.

Policy issues for Congress going forward could include the following:

- Should the Fed be doing more to combat climate change? Or should it be doing less on the grounds that climate change is outside the Fed's purview and a distraction from its statutory duties? If Congress wants the Fed to address climate change, should those responsibilities be added through legislation? Are U.S. interests better served inside or outside of the Network for Greening the Financial System? Should Congress have more input on internationally negotiated bank climate risk standards, or would that disadvantage the United States in negotiations?[107]

Course of the Exercise," press release, January 17, 2023, https://www.federalreserve.gov/newsevents/pressreleases/other20230117a.htm.

[103] BCBS, *Disclosure of Climate Related Financial Risks*, November 29, 2023, https://www.bis.org/bcbs/publ/d560.pdf.

[104] Testimony of Michael Barr, in U.S. Congress, House Committee on Financial Services, *Oversight of Prudential Regulators*, 118th Cong., 2nd Sess., November 20, 2024, https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=409407.

[105] FSOC, "Financial Stability Oversight Council Identifies Climate Change as an Emerging and Increasing Threat to Financial Stability," press release, October 21, 2021, https://home.treasury.gov/news/press-releases/jy0426.

[106] See, for example, John H. Cochrane, "The Fallacy of Climate Financial Risk," *Project Syndicate*, July 21, 2021, https://www.project-syndicate.org/commentary/climate-financial-risk-fallacy-by-john-h-cochrane-2021-07.

[107] In the 118th Congress, H.R. 4790 passed the House. It would have prohibited the Fed (and certain other regulators) from engaging with certain international organizations on climate risk unless the Fed provided a report on the activities and financing of the organization.

- Should the Fed continue to study the economic and financial effects of climate change to understand how monetary policy and financial stability might be affected by climate change or policies to prevent climate change? Does climate risk expose banks to unmanageable financial risks or the financial system to systemic risk?
- Are climate stress tests an appropriate tool for managing climate risk? If so, should stress tests be limited to climate risk or also include transition risks imposed by potential policy changes, as the Fed is not responsible for and cannot predict climate policy?

Cryptocurrency and Banking

Some banks have expressed interest in offering services related to cryptocurrencies and other digital assets (crypto).[108] Participation could take the form of traditional banks providing some types of cryptocurrency services or cryptocurrency firms seeking bank charters. The Fed, OCC, and FDIC have identified areas where (traditional or crypto) banks could seek to engage in crypto-related activities, such as issuing payment stablecoins, providing custody services, facilitating crypto transactions for customers, making loans using crypto as collateral, and holding crypto on their own balance sheets.[109] In addition, banks can offer traditional banking services, such as loans or deposit accounts, to cryptocurrency firms.

Extreme volatility in crypto values and several high-profile scandals involving collapses in crypto firms, crypto scams, and thefts point to the dangers that crypto could pose for bank safety and soundness and their customers if risks are not properly managed. Broadly, bank regulators' enthusiasm for potential bank participation in crypto markets has waxed and waned in recent years in response to changes in agency leadership and crypto market events. Following the failure of one of the largest crypto exchanges (FTX) in 2022[110] and the liquidation of two banks (Silvergate and Signature) with crypto exposure in 2023,[111] the bank regulators' approach to crypto arguably shifted from ambivalence to greater caution and skepticism.

In August 2023, the Fed created a Novel Activities Supervision Program as a dedicated group to supervise banks' technology-driven partnerships, crypto activities, use of distributed ledger technology, and provision of banking services to crypto and fintech firms. The group supervises banks alongside its existing supervisory team.[112]

Policy issues surrounding stablecoins are discussed below in the section entitled "Payment Stablecoins."

[108] For background, see CRS In Focus IF12405, *Introduction to Cryptocurrency*, by Paul Tierno.

[109] Although U.S. regulators have not yet determined under what circumstances banks could hold crypto assets on their balance sheets, the BCBS (an international forum to devise regulatory standards) is in the process of formulating international capital standards for bank exposures to crypto. Typically, U.S. bank regulators have implemented BCBS standards through the domestic rulemaking process. BCBS, *Second Consultation on the Prudential Treatment of Cryptoasset Exposures*, June 2022, https://www.bis.org/bcbs/publ/d533.pdf. See also Federal Reserve, FDIC, and OCC, "Joint Statement on Crypto-Asset Policy Sprint Initiative and Next Steps," November 23, 2021, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20211123a1.pdf.

[110] See CRS Insight IN12047, *What Happened at FTX and What Does It Mean for Crypto?*, by Paul Tierno.

[111] See CRS Insight IN12148, *The Role of Cryptocurrency in the Failures of Silvergate, Silicon Valley, and Signature Banks*, by Paul Tierno.

[112] Federal Reserve, "Creation of Novel Activities Supervision Program," August 8, 2023, https://www.federalreserve.gov/supervisionreg/srletters/SR2307.htm.

For more information, see CRS In Focus IF12320, *Crypto and Banking: Policy Issues*, by Marc Labonte, Andrew P. Scott, and Paul Tierno.

Traditional Bank Participation in Crypto[113]

When it comes to traditional banking services, such as making loans and accepting deposits, provided to crypto firms (if performed safely and soundly), the regulators have emphasized that banks "are neither prohibited nor discouraged from providing banking services to customers of any specific class or type, as permitted by law or regulation."[114]

Banks cannot engage in novel activities without supervisory approval. Bank involvement in a nontraditional crypto activity faces a two-prong regulatory test. First, an activity must be permissible under law—Congress has limited banks' activities related or incidental to the business of banking. (Certain nonbank subsidiaries of banks and BHCs can also engage in activities that are financial in nature.[115]) Second, an activity must be safe and sound. Federal banking regulators have significant discretion over both findings, and their interpretation has changed under different leadership. Agency leadership appointed by President Trump in his first term approved several specific activities involving crypto so long as banks could conduct them on a safe and sound basis. Agency leadership appointed by President Biden required case-by-case supervisory approval before a bank could undertake any crypto activity and expressed "significant safety and soundness concerns with business models that are concentrated in crypto-asset-related activities or have concentrated exposures to the crypto-asset sector."[116]

The Fed issued guidance in 2022 stating that banks cannot engage in crypto activities until they have been explicitly approved by their regulators.[117] For state-chartered banks under its jurisdiction, the Fed's approach is to defer to the OCC and FDIC where those regulators have made a determination on what activity is permissible under law and laid out limitations surrounding the activity. The Fed has stated that where there is a "clear and compelling rationale" it could deviate from standards set by the OCC and FDIC and approve an activity, but it stated that to date it has not done so for any crypto activity.[118] When the OCC or FDIC has not made a determination, a bank cannot carry out an activity until the Fed has granted approval, which requires the Fed to be satisfied that the activity can be carried out in a safe and sound manner. Separately, the Fed determines permissible activities for BHCs and financial holding companies (and their nonbank subsidiaries) by regulation. In later guidance, the Fed specifically stated that it will "presumptively prohibit" banks from holding most crypto assets as principal (as opposed to holding it on behalf of a customer), as it has not found any statutory authority for banks to do so and does not believe that banks could do so in a safe and sound manner.[119]

[113] This section draws on material coauthored with Andrew Scott and Paul Tierno.

[114] Federal Reserve, FDIC, and OCC, "Joint Statement on Crypto-Asset Risks to Banking Organizations," January 3, 2023, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230103a1.pdf.

[115] For more information, see CRS Report R48291, *Bank Holding Companies: Background and Issues for Congress*, by Marc Labonte.

[116] Federal Reserve, FDIC, and OCC, "Joint Statement on Crypto-Asset Risks to Banking Organizations."

[117] Federal Reserve, "Engagement in Crypto-Asset-Related Activities by Federal Reserve-Supervised Banking Organizations," August 16, 2022, https://www.federalreserve.gov/supervisionreg/srletters/SR2206.htm.

[118] The Fed refers to this as a "rebuttable presumption" that an activity is not permitted if the FDIC or OCC have found it to not be permitted. Federal Reserve, "Policy Statement on Section 9(13) of the Federal Reserve Act," 88 *Federal Register* 7848, February 7, 2023, https://www.govinfo.gov/content/pkg/FR-2023-02-07/pdf/2023-02192.pdf.

[119] Federal Reserve, "Policy Statement on Section 9(13)."

Congress has debated whether to create a broader regulatory framework for crypto that might include provisions addressing the relationship between banking and crypto.[120]

Policy issues for Congress going forward could include the following:

- Are some crypto activities inherently too risky for banks or BHCs to participate in, as evidenced by the failures of banks with crypto exposure in 2023? Do crypto activities pose more risk to consumers and financial stability if they are inside or outside of the banking system?
- Are limits on traditional bank services provided to the crypto industry necessary from a safety and soundness perspective, or are they unfairly discriminating against the crypto industry? Is rulemaking needed to ensure equal treatment, or are the current rules well suited to recent developments?
- Are crypto activities part of or incidental to the business of banking as required for it to be a permissible activity? Does crypto provide some public benefit or purpose that warrants bringing it inside the federal bank safety net? Should Congress make it explicit that they are or are not permissible activities? Should Congress preempt regulatory action to ensure that banks may or may not participate in certain aspects of crypto markets? Is a legislative framework needed to prevent inconsistency in regulatory treatment across leadership?

Crypto Firms Seeking Fed Membership and Master Accounts

Some firms specializing in crypto services have sought bank charters in order to enjoy some of the associated benefits, such as access to a Fed master account. Some crypto firms have received trust charters or other special purpose charters from the OCC or state bank regulators, most notably a special purpose depository institution (SPDI) charter from the state of Wyoming.[121] The OCC or state granting the charter could potentially impose limits on activities that the firm could engage in, such as deposit taking.

Generally, banks that do not accept insured deposits are not subject to all of the same regulations as are banks that accept deposits and would not have a primary federal regulator unless they are federally chartered or are members of the Federal Reserve System. State-chartered institutions, including those with nontraditional charters, have the option to apply to become state member banks, in which case the Fed would become their primary federal regulator.

Custodia is a Wyoming SPDI focused on crypto that applied to join the Federal Reserve System, stating in its application that it did not intend to seek federal deposit insurance. In 2023, the Fed denied Custodia's membership application. Some of the Fed's reasons for denial were specific to deficiencies it identified in Custodia's application, but some had broader implications for crypto firms becoming state member banks. In its denial, the Fed stated that Custodia had

> an unprecedented business model that presents heightened risks involving activities that no state member bank previously has been approved to conduct.… Given the speculative and

[120] In the 118th Congress, H.R. 4763 would have created a broader regulatory framework for crypto and would have confirmed that banks may provide custody services for crypto and other digital assets and prohibited the bank regulators from imposing capital requirements that would discourage banks from offering custody services for crypto. For more information, see CRS Insight IN12223, *An Overview of H.R. 4763, Financial Innovation and Technology for the 21st Century Act,* by Paul Tierno and Eva Su.

[121] For more information, see CRS Report R47014, *An Analysis of Bank Charters and Selected Policy Issues*, by Andrew P. Scott.

> volatile nature of the crypto-asset ecosystem, the Board does not believe that this business model is consistent with the purposes of the Federal Reserve Act.…
>
> [T]he future earnings prospects of the business model that Custodia has proposed—that is, an uninsured, undiversified, crypto-asset-focused business model featuring a number of novel and untested activities posing heightened risks—is inconsistent with approval.[122]

Some crypto firms are also interested in receiving Fed master accounts, which would provide direct access to the traditional payment system.[123] Along with other nontraditional applicants, such as fintech firms, this has led to greater scrutiny on who should be granted master accounts.[124] The Fed issued final guidance in August 2022 through the notice-and-comment process explaining how it would evaluate master account applications.[125] Applicants that are federally insured depository institutions receive the least scrutiny, institutions that are not federally insured but are subject to prudential supervision by federal banking agencies or have holding companies that are supervised by the Fed receive more scrutiny, and eligible institutions that are not federally insured and do not have holding companies supervised by the Fed but have state or federal charters receive the most scrutiny.

Two applicants have had their requests for master accounts rejected since December 2022—Custodia and a fintech firm. In addition, at least two crypto firms (Kraken Financial and Protego) have applications currently pending, and three (Bankwyse, Commercium Financial, and Paxos) have withdrawn their applications.[126] Custodia has sued the Fed for rejecting its master account application.[127] Custodia lost its case in district court but appealed the case to the Court of Appeals in 2024.[128] The district court found that the Fed has discretion to reject master account applicants:

> [U]nless the Federal Reserve Banks possess discretion to deny or reject a master account application, state chartering laws would be the only layer of insulation for the U.S. financial system. And in that scenario, one can readily foresee a "race to the bottom" among states and politicians to attract business by reducing state chartering burdens through lax legislation, allowing minimally regulated institutions to gain ready access to the central bank's balance sheet and Federal Reserve services. As [the Federal Reserve Bank of Kansas City] accurately notes, "The Wyoming Division of Banking … has many purposes and aims, but protecting the *national* financial system and implementing *national* monetary policy are not among them…. States lack not only the mission but also the resources to protect national interests."[129]

Policy issues for Congress going forward could include the following:

---

[122] Federal Reserve, "Custodia Bank, Inc. Cheyenne, Wyoming, Order Denying Application for Membership," January 27, 2023, https://www.federalreserve.gov/newsevents/pressreleases/files/orders20230324a1.pdf.

[123] See the section below entitled "Payments."

[124] For more information, see CRS Insight IN12031, *Federal Reserve: Master Accounts and the Payment System*, by Marc Labonte.

[125] Federal Reserve, "Guidelines for Evaluating Account and Services Requests," 87 *Federal Register* 51099, August 19, 2022.

[126] CRS search of Fed master accounts database at https://www.federalreserve.gov/paymentsystems/master-account-and-services-database-access-requests.htm.

[127] Kyle Campbell, "Custodia Amends Fed Lawsuit, Alleges 'Coordinated Effort' to Deny Master Account," *American Banker*, February 17, 2023, https://www.americanbanker.com/news/custodia-amends-fed-lawsuit-alleges-coordinated-effort-to-deny-master-account.

[128] The case can be found at https://www.courtlistener.com/docket/68486662/custodia-bank-v-federal-reserve-board-of-governors/.

[129] United States District Court District of Wyoming Custodia Bank, Inc., Plaintiff, v. Federal Reserve Board of Governors, and Federal Reserve Bank of Kansas City, Case No. 22-Cv-125-Sws, March 29, 2024, https://storage.courtlistener.com/recap/gov.uscourts.wyd.61107/gov.uscourts.wyd.61107.317.0.pdf.

- Should crypto firms and other nontraditional firms with federal or state bank charters be granted direct access to the Fed's discount window and master accounts? Should Congress determine who gets access through legislation or defer to the Fed?
- Should the Fed approve requests from state-chartered crypto firms to become members of the Federal Reserve System? Should Congress determine who can be a member bank through legislation or defer to the Fed?

Payments

Because banks and select other institutions maintain master accounts at the Fed to hold their reserves, those accounts can be used to facilitate interbank payments. To that end, the Fed operates the following interbank payment systems for those institutions:

- The Automated Clearinghouse (ACH) for credit and debit transfers, such as direct deposits and direct debits;
- Check clearing;
- Fedwire Funds Service for gross settlement of large value payments;
- Fedwire Securities Service for settlement of government and government agency securities;
- The National Settlement Service for multilateral payment settlement among the largest payment market participants; and
- FedNow, a real-time settlement system that allows banks to offer real-time retail payments, which launched in July 2023.[130]

The Fed offers intraday credit to participants in its payment services to help them avoid settlement failure. It also acts as the federal government's fiscal agent: Federal receipts and payments flow through Treasury's accounts at the Fed.

The Fed also sets risk management standards for private sector wholesale payment systems, which in some cases directly compete with the Fed's payment systems.[131] For example, the Electronic Payments Network also operates an ACH network that is interoperable with the Fed's ACH. However, the Fed does not have plenary authority to regulate all aspects of payments, and payment system participants that are not banks are not all under its jurisdiction.[132] Title VIII of the Dodd-Frank Act subjects payment, clearing, and settlement systems designated as systemically important financial market utilities by FSOC to enhanced supervision by the Fed.[133] Since 2012, the Fed has regulated two such systems: the Clearing House Payments Company and CLS Bank International. The Fed—in some cases, jointly—regulates how banks make funds

[130] For more information, see CRS Insight IN12207, *Federal Reserve Launches FedNow*, by Marc Labonte.

[131] Federal Reserve, *Policy on Payment System Risk*, March 19, 2021, https://www.federalreserve.gov/paymentsystems/files/psr_policy.pdf.

[132] Lael Brainard, "The Digitalization of Payments and Currency: Some Issues for Consideration," Federal Reserve, speech at the Symposium on the Future of Payments, Stanford Graduate School of Business, Stanford, CA, February 5, 2020.

[133] Title VIII assigns payment, clearing, and settlement systems a primary regulator, which can be the Fed, the Securities and Exchange Commission, or the Commodity Futures Trading Commission, depending on the type of system.

available to depositors. Under the "Durbin Amendment" (Regulation II), the Fed caps debit interchange fees on large banks.[134]

As noted above, access to Fed master accounts has become controversial in recent years, as crypto and fintech firms with bank charters have applied. In the 117th Congress, Title LVIII, Subtitle F, of the National Defense and Authorization Act for FY2023 (P.L. 117-263) required the Fed to publicly release a quarterly list of institutions (excluding official institutions) that have requested, been rejected for, or been granted master accounts. The Fed maintains a public database to comply with this law.[135]

Current payment systems issues of potential interest to Congress are discussed below.

Payment Stablecoins

Stablecoins are cryptocurrencies that are tied in value to some reference currency.[136] For example, some stablecoins are set equal in value to the U.S. dollar. Some stablecoins are backed by assets in an effort to maintain their stable value against the dollar. Stablecoins have many potential uses, including to make retail payments, although stablecoins make up an insignificant fraction of total traditional payments currently. Stablecoins that are used—or, in some cases, have the potential to be used—to make retail payments are referred to as payment stablecoins.

Stablecoins face run risk. Stablecoin holders who seek to convert into dollars rely on the issuers' ability to meet redemption demands. If holders believe that an issuer is unable to meet all redemption demands, then they benefit from being among the first to redeem. This can result in runs that cause the stablecoin's value to collapse because the underlying assets are of insufficient value or because they are too illiquid to meet redemption demands promptly. Whether this run risk should be regulated depends on whether there is some policy justification for addressing it. Potential justifications include consumer protection and promoting innovation in payments. Moreover, run risk potentially poses systemic risk if stablecoins grow or become interconnected with the traditional financial system, as FSOC has argued.[137]

In 2023, the Fed issued guidance that banks it regulates are permitted to issue dollar-denominated tokens, such as payment stablecoins, if they receive approval from the Fed by demonstrating that they can do so in a safe and sound manner. However, the Fed stated that it "generally believes that issuing tokens on open, public, and/or decentralized networks, or similar systems is highly likely to be inconsistent with safe and sound banking practices" because of operational, cybersecurity, run, and illicit finance risks.[138] Arguably, the Fed has created an approval process that rules out any stablecoin operating on an open decentralized network from ever being

[134] In 2023, the Fed issued a proposed rule to lower those fees. See Federal Reserve, "Federal Reserve Board Requests Comment on a Proposal to Lower the Maximum Interchange Fee That a Large Debit Card Issuer Can Receive for a Debit Card Transaction," press release, October 25, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231025a.htm.

[135] The database is available at https://www.federalreserve.gov/paymentsystems/master-account-and-services-database-about.htm.

[136] For background, see CRS In Focus IF11968, *Stablecoins: Background and Policy Issues*, by Eva Su.

[137] FSOC, *Report on Digital Asset Financial Stability Risks and Regulation*, October 2022, https://home.treasury.gov/system/files/261/FSOC-Digital-Assets-Report-2022.pdf.

[138] Federal Reserve, "Policy Statement on Section 9(13)." In August 2023, the Fed laid out an approval process for banks requesting permission to issue dollar tokens, noting the various risks that would need to be addressed for approval to be granted. Federal Reserve, "Supervisory Nonobjection Process for State Member Banks Seeking to Engage in Certain Activities Involving Dollar Tokens," August 8, 2023, https://www.federalreserve.gov/supervisionreg/srletters/SR2308.htm.

approved, but it has permitted the tokenized deposits—which may serve a similar function to a payment stablecoin—that some large banks have developed.[139] Bank regulators also identified bank deposits that are stablecoin reserves as posing "heightened liquidity risks to banking organizations due to the unpredictability of the scale and timing of deposit inflows and outflows."[140]

Some Members of Congress from both parties, as well as the Treasury and banking regulators,[141] have called for legislation to regulate payment stablecoins, although there is not consensus on what form it should take. Some proposals would allow banks to issue stablecoins through subsidiaries under the supervision of their primary regulators, including the Fed for state member banks. Other proposals would give the Fed rulemaking authority over nonbanks that issue stablecoins.[142]

Policy issues for Congress going forward could include the following:

- Should payment stablecoins or all stablecoins be regulated for safety and soundness? If so, would the Fed be the most appropriate regulator? For regulatory purposes, can workable legal distinctions be made among tokenized deposits, payment stablecoins, and other stablecoins?
- Should banks, nonbanks, or both be permitted to issue stablecoins given financial stability concerns? If so, should bank issuance be limited to payment stablecoins? Can regulators allow banks to issue stablecoins under existing authority, or would legislation be required?
- Should stablecoins have access to federal deposit insurance, Fed master accounts, and the Fed's discount window?

For more information, see CRS In Focus IF12450, *Stablecoin Policy Issues for the 118th Congress*, by Paul Tierno.

Central Bank Digital Currency[143]

The recent proliferation of cryptocurrencies, such as Bitcoin, has led to questions of whether the Fed should create a central bank digital currency (CBDC)—a digital dollar that would share some of the features of these private digital currencies.

According to the Atlantic Council, 134 jurisdictions around the world were engaged in CBDCs at some level (researching, piloting, or launching) as of September 2024.[144] Although no major economy has formally launched a CBDC, China is the furthest in its digital currency development. China has piloted the digital yuan (e-CNY), with about 260 million wallet users in China and across a multinational financial framework. Several central banks in advanced economies are also researching and piloting CBDCs. For example, the European Central Bank is in a two-year preparation phase for a digital euro, the Bank of England is beginning work on a

[139] See CRS In Focus IF12670, *Tokenized Assets*, by Paul Tierno.

[140] Federal Reserve, FDIC, and OCC, "Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities," February 23, 2023, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230223a1.pdf.

[141] President's Working Group on Financial Markets, FDIC, and OCC, *Report on Stablecoins*, November 1, 2021, https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf.

[142] See, for example, H.R. 4766 in the 118th Congress.

[143] This section draws from other CRS products coauthored with Rebecca Nelson.

[144] Available at https://www.atlanticcouncil.org/cbdctracker/.

digital pound, and the Swiss National Bank has announced plans to test a wholesale CBDC. The "Innovation Hub" at the Bank for International Settlements (an international organization of central banks) is working with a range of countries on CBDC research projects, including cross-border pilots. Countries such as China, Iran, Russia, and Venezuela also view CBDCs as a way to reduce reliance on the dollar and reduce vulnerability to U.S. sanctions. Russia recently proposed using the technology from a cross-border pilot involving China called Project mBridge to create a cross-border payment system that could avoid U.S. sanctions.[145] The proliferation of CBDCs around the world has raised questions about whether the United States is falling behind in the future of the financial system and whether that could affect its predominant "reserve currency" status in international trade and payments.[146]

Digital payments and account access are already widespread in the United States. A key question from an end-user (e.g., consumer or merchant) perspective is whether a CBDC would be faster, more reliable, and less expensive than the current system. A CBDC would presumably allow for real-time settlement of payments—a feature that is not currently ubiquitous in the U.S. payments system but may become so now that the Fed has introduced FedNow, its real-time settlement system. Whether payments using a CBDC would be less expensive than the status quo remains unknowable until detailed proposals have been made. (Using CBDCs for cross-border payments has been identified as offering greater potential gains in cost and speed.)

From an end-user perspective, CBDC proposals range from a payment system similar to the status quo to one that is fundamentally different. At one end of the spectrum of proposals, a CBDC accessible only to banks may differ only slightly from the current system given that wholesale payment systems are already digital. At the other end, proposals for consumers to be able to hold CBDCs in accounts at the Fed—where they could receive government payments in CBDC—would fundamentally change the role of the Fed and its relationship with consumers and banks. Thus, depending on its attributes, a domestic CBDC could potentially compete with private digital currencies, foreign CBDCs, private payment platforms, or banks. CBDC proponents differ as to which of these they would like a domestic CBDC to compete with. CBDCs are more likely to compete with private digital currencies as a payment means for legal commerce than to function in their other current uses (e.g., as speculative investments or as payment means for illicit activities).

Depending on its features and how much it differed from the status quo, a U.S. CBDC would have an ambiguous but potentially significant effect on financial inclusion, financial stability, cybersecurity, Federal Reserve independence, seigniorage,[147] and the effectiveness of monetary policy. If the CBDC mainly crowded out cash and cryptocurrency use, it could make illicit activity more difficult, potentially at the expense of some individual privacy.

On January 23, 2025, President Donald Trump issued an executive order on digital financial technology.[148] The order stated that agencies are prohibited from "undertaking any action to establish, issue, or promote a CBDC" and should "terminate any plans or initiatives related to the creation of a CBDC." To date, the Fed has not taken a position on whether creating a CBDC

---

[145] Reuters, "BIS to Leave China-Backed Central Bank Digital Currency Project," October 31, 2024, https://www.reuters.com/business/finance/bis-leave-cross-border-payments-platform-project-mbridge-2024-10-31.

[146] For more information, see CRS In Focus IF11707, *The U.S. Dollar as the World's Dominant Reserve Currency*, by Rebecca M. Nelson and Martin A. Weiss.

[147] An expansive definition of *seigniorage* is the income the government obtains from having government (including central bank) liabilities act as money.

[148] The White House, "Strengthening American Leadership in Digital Financial Technology," January 23, 2025, https://www.whitehouse.gov/presidential-actions/2025/01/strengthening-american-leadership-in-digital-financial-technology/.

would be desirable. In a 2022 report, the Fed stated that it "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."[149] The report argued against a FedAccounts model (where the Fed would offer retail services directly to consumers) and argued for allowing individuals to use a CBDC directly (as opposed to limiting their use to financial institutions). The Fed has undertaken various research pilot projects to develop technical expertise in how to operate a CBDC. CRS cannot locate any statement from the Fed on whether it intends to terminate its research in response to the executive order. Congress might choose to legislate in order to either explicitly authorize or mandate the Fed to create a CBDC and shape its features and uses or to prohibit one from being introduced.[150]

Policy issues for Congress going forward could include the following:

- Would a CBDC crowd out private financial services in the areas of cryptocurrency, payments, or banking?
- Would CBDCs be less costly and more efficient than the current payment system? Or is a CBDC a "solution in search of a problem"? What practical advantages would a CBDC provide compared to FedNow?
- Could international coordination on CBDCs improve the efficiency of cross-border transactions?
- How would a CBDC balance privacy and preventing illicit activity?
- How could the U.S. dollar be affected by other countries' adoption of CBDCs?
- Should the decision to introduce a CBDC be made by Congress, the Administration, or the Fed?

For more information, see CRS In Focus IF11471, *Central Bank Digital Currencies*, by Marc Labonte and Rebecca M. Nelson.

Lender of Last Resort

Despite their name, Federal Reserve banks do not carry out any commercial banking activities, with one limited exception: The Fed makes short-term loans to commercial banks through its discount window.[151] The Fed was originally created primarily to act as a lender of last resort (LOLR) through its discount window. Over time, the Fed's other responsibilities grew out of this role, and the LOLR role became secondary.

Typically, the Fed's LOLR operations are minimal, because banks can borrow privately to meet their liquidity needs. But during periods of financial instability, such as the 2007-2009 financial crisis and the COVID-19 pandemic, LOLR operations grew rapidly as private sources of liquidity dried up. To borrow from the discount window, banks pledge their assets as collateral, temporarily converting illiquid assets (such as mortgages) into liquid reserves. Banks that are adequately capitalized and are not poorly rated by their supervisors use *primary credit* and can borrow for up to 90 days with "no questions asked." Poorly capitalized or rated banks must use

[149] Federal Reserve, *Money and Payments: The U.S. Dollar in the Age of Digital Transformation*, January 2022, https://www.federalreserve.gov/publications/files/money-and-payments-20220120.pdf.

[150] In the 118th Congress, H.R. 5403, which would have prohibited the Fed from issuing a CBDC without congressional authorization, passed the House.

[151] The Fed's lending facility is called the discount window because in the Fed's early years, a bank that wanted a loan would take its securities to a window at its Federal Reserve bank to be discounted. Today, the Fed makes advances instead.

secondary credit, which is shorter term and subject to close oversight. *Seasonal credit* is also available for small banks to manage seasonal inflows and outflows. The Fed sets the *discount rate* charged for loans. Traditionally the primary credit rate was set above market rates, but since the pandemic it has been set at the top of the FFR target range. The secondary credit rate is set higher.

Less commonly, the Fed has also provided liquidity to firms that were not banks (and sometimes to banks as well) under emergency authority found in Section 13(3) of the Federal Reserve Act.[152] After the Great Depression, this authority was not used extensively again until the 2007-2009 financial crisis. Subsequently, it was used during the COVID-19 pandemic and again following large bank failures in 2023. In the financial crisis and the pandemic, the Fed used that authority to create a series of temporary emergency facilities to support nonbank financial markets and firms. Since the financial crisis, the Fed has financed discount window lending and credit through its emergency facilities by expanding its balance sheet.

Section 13(3)

Section 13(3), as amended by the Dodd-Frank Act, allows the Fed, subject to approval by the Treasury Secretary, to set up temporary broad-based facilities for the purpose of providing liquidity to the financial system when the Fed finds that there are unusual and exigent circumstances. There are few practical limitations on the types of actions the Fed can take under Section 13(3) except that there are several provisions to prevent the Fed from "bailing out" a failing firm.

Pandemic LOLR Actions

As noted above, the Fed created a series of emergency programs to stabilize economic conditions during the pandemic. Congress took the unprecedented step of providing at least $454 billion and up to $500 billion to the Treasury to support some of these programs through the Coronavirus Aid, Relief, and Economic Security Act (CARES Act, P.L. 116-136). Assistance outstanding under these facilities peaked at nearly $200 billion in April 2020 then hovered around $100 billion for the rest of the year. Programs expired at the end of 2020 or in March 2021, but a small amount of loans still remain outstanding.[153]

Bank Term Funding Program

Following a run on large (but not the largest) banks, discount window lending during the spring of 2023 suddenly spiked and reached an all-time high (in nominal dollars) of $295.7 billion on March 15, 2023. The bulk of that lending went initially to the three large banks that failed (SVB, Signature, and First Republic) and then to the FDIC to finance its resolution of those banks. At the same time, the Fed also created the Bank Term Funding Program (BTFP) under Section 13(3) to allow banks to borrow against securities whose market values were less than their book values. SVB failed in part because it had to sell securities at a loss to honor deposit outflows. When interest rates rose, banks' unrealized losses on securities became very large. BTFP loans

---

[152] 12 U.S.C. §343. See CRS Report R44185, *Federal Reserve: Emergency Lending*, by Marc Labonte.

[153] For more information, see CRS Report R46411, *The Federal Reserve's Response to COVID-19: Policy Issues*, by Marc Labonte.

outstanding peaked at $168 billion. The BTFP expired in March 2024, and all loans will mature within a year of its expiration.[154]

Discount Window Reforms

Although discount window lending spiked in 2023, some believe that the discount window did not function as smoothly as it could have for the banks that failed and for the broader banking system.[155] Various explanations for this (which are not mutually exclusive) include (1) perceived stigma caused banks to be reluctant to borrow, (2) a lack of preparedness by banks slowed the borrowing process, (3) outdated Fed technology and procedures slowed the borrowing process, and (4) Federal Home Loan Bank lending to banks impeded the discount window's LOLR function. The episode also raised questions about the effectiveness of large bank liquidity rules and their relationship to discount window borrowing.

In July 2023, the bank regulators issued updated guidance encouraging—but not requiring—banks to be prepared to use the discount window, including by pre-pledging collateral, and to periodically test their preparedness.[156] The Fed reported that 3,900 out of 4,824 eligible banks had signed up to use the discount window in 2023 (up from 3,561 in 2022) and 1,996 had pre-pledged collateral.[157] In September 2024, the Fed issued a request for information as part of its initiative to modernize the discount window.[158]

Policy issues for Congress moving forward could include the following:

- Were the loans to failing banks in 2023 an appropriate use of the discount window? Should changes be made to discount window eligibility to more effectively restrict loans to failing banks?
- Does stigma associated with the discount window dissuade banks from borrowing in times of stress, thereby reducing its effectiveness? If so, can stigma be reduced without encouraging unhealthy banks to be overly reliant on the discount window? Do statutorily required disclosures strike the right balance between transparency and stigma?

---

[154] For more information, see CRS Insight IN12134, *Bank Term Funding Program (BTFP) and Other Federal Reserve Support to Banking System in Turmoil*, by Lida R. Weinstock and Marc Labonte.

[155] In the 118th Congress, H.R. 8337 would have required the Fed to conduct a review of the effectiveness of the discount window, develop a remediation plan of any deficiencies identified in the review, and issue a report to Congress. H.R. 3556, among other things, would have accelerated the public disclosure of open market operations and discount window lending records from two years to one year, expanded the scope of information that Congress could request from the Fed about its 13(3) emergency facilities, provided access to nonpublic emergency lending records (including personal information) to the committees of jurisdiction upon request, and removed restrictions on GAO providing transaction records from Fed lending facilities to Congress, including information on the identities of borrowers.

[156] Federal Reserve, FDIC, National Credit Union Administration, and OCC, "Agencies Update Guidance on Liquidity Risks and Contingency Planning," joint press release, July 28, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230728a.htm.

[157] Fewer credit unions have signed up. Data at https://www.federalreserve.gov/monetarypolicy/discount-window-readiness.htm.

[158] Federal Reserve, "Request for Information and Comment on Operational Aspects of Federal Reserve Bank Extensions of Discount Window and Intraday Credit," 89 *Federal Register* 73415, September 10, 2024, https://www.federalregister.gov/documents/2024/09/10/2024-20418/request-for-information-and-comment-on-operational-aspects-of-federal-reserve-bank-extensions-of.

- Should discount window readiness—through registration, testing, and prepositioning collateral—be mandatory for banks, or is the guidance issued in 2023 encouraging them to voluntarily do so sufficient?
- Did the 2023 episode illustrate that banks are using the Federal Home Loan Banks as an alternative to the discount window, and is this interfering with the proper functioning of the discount window?
- Are the Fed's efforts to modernize the discount window sufficient and happening in a timely manner?
- Should banks get credit for discount window borrowing capacity in large bank liquidity rules? If so, should existing rules be modified, or should new rules be added?
- Has the Fed's emergency 13(3) lending authority been used appropriately, or are new statutory restrictions necessary? Were the COVID-19 emergency programs and the BTFP an appropriate use of that authority? Was it appropriate for the Treasury to use its Exchange Stabilization Fund to backstop potential losses on a subset of emergency Fed programs? Are some of these programs better suited to Treasury than Fed administration?
- Do the benefits of emergency lending, such as quelling liquidity panics, outweigh the costs, including moral hazard? Has the Fed created a moral hazard problem where financial markets expect every recession to bring 13(3) facilities, thereby leading financial participants to take on greater risks in the expectation of Fed support? If so, are changes to the Fed's lending or regulatory powers appropriate to mitigate that risk?
- Did the BTFP provide regulatory forbearance by allowing banks to avoid cleaning up the unrealized losses on their balance sheets? Did the BTFP rely on Section 13(3) as an end around of the statutory restrictions on the discount window?
- Should the Fed make discount window loans to provide short-term financing of FDIC resolutions, or should the FDIC use its line of credit to the Treasury to meet its liquidity needs?

For more information, see CRS In Focus IF12655, *Federal Reserve's Discount Window: Policy Issues*, by Marc Labonte.

Author Information

Marc Labonte
Specialist in Macroeconomic Policy

Acknowledgments

This report draws on previously published material, including with coauthors Lida Weinstock, Paul Tierno, Rebecca Nelson, and Andrew Scott.

Disclaimer