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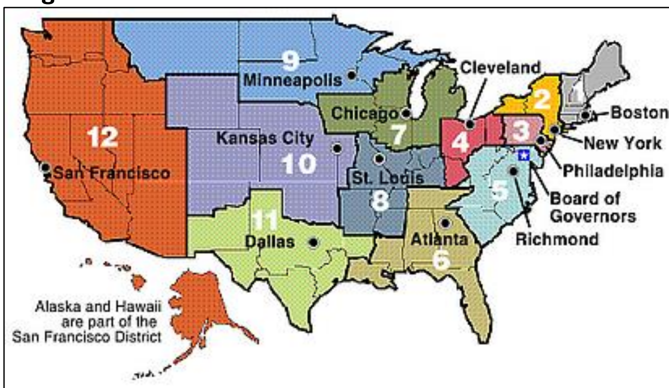
Introduction to Financial Services: The Federal Reserve

Structure of the Federal Reserve

The Federal Reserve Act (12 U.S.C. 221 et seq.) created the Federal Reserved (Fed) as the nation's central bank in 1913. The Fed is composed of 12 regional Federal Reserve banks overseen by a Board of Governors in Washington, DC. **Figure 1** illustrates the city in which each bank is headquartered and the area of each bank's jurisdiction. The board is composed of seven governors nominated by the President and confirmed by the Senate. The President selects (and the Senate confirms) a chair and two vice chairs from among the governors; one vice chair is responsible for supervision. The governors serve nonrenewable 14-year terms, but the chair and vice chairs serve renewable 4-year terms. Jerome Powell's term as chair began February 5, 2018. Board members are chosen without regard to political affiliation. Regional bank presidents are chosen by their boards, not by the President, with the approval of the Board of Governors.

Figure 1. Federal Reserve Districts



Source: Federal Reserve.

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

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

The Fed's capital consists of stock and a surplus. The Fed's surplus is capped at $6.825 billion by law. Private banks regulated by the Fed buy stock in the Fed to become *member banks*. Membership is mandatory for national banks, but optional for state banks. The stock pays dividends of 6% for banks with less than $10 billion in assets and the lower of 6% or the 10-year Treasury yield for banks with more than $10 billion in assets. Stockholders choose two-thirds of the board at the regional Fed banks.

Responsibilities of the Federal Reserve

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

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

The Fed targets the federal funds rate through *open market operations*—the purchase and sale of U.S. Treasury securities, mainly from primary dealers (who specialize in trading government securities), in the secondary market. Often, these transactions are made on a temporary basis using repurchase agreements, known as *repos*. The Fed sets reserve requirements and the interest rate it pays banks to hold reserves. In addition, monetary policy can involve foreign exchange operations, although these are rare. Open market and foreign exchange operations are conducted by the New York Fed per the FOMC's directives. The Fed influences the money supply through its control over bank reserves and currency in circulation.

During the 2007-2009 financial crisis, the Fed reduced the federal funds rate to zero and conducted large-scale asset purchases of Treasury- and mortgage-backed securities from 2008 to 2014—known as *quantitative easing*—that increased the size of its balance sheet. The Fed then began to *normalize* monetary policy. From 2015 to 2018, the Fed initiated a series of increases in the federal funds rate. From 2017 to 2019, the Fed gradually reduced the size of its balance sheet. However, an economic slowdown in 2019 prompted the Fed to cut rates and repo market instability prompted the Fed to begin expanding its balance sheet again in October. A large balance sheet has boosted the Fed's remittances to the Treasury in recent years.

Lender of Last Resort. Despite their name, Federal Reserve banks do not carry out any banking activities, with one limited exception. The Fed traditionally acts as lender of last resort by making short-term, collateralized loans to

banks through its discount window. The Fed generally sets the *discount rate* charged for these loans above market rates. In normal market conditions, the Fed's lending operations are minimal. In the financial crisis, it created a number of temporary facilities to provide extensive assistance to banks and nonbank financial firms using emergency authority.

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

Payment Systems. The Fed operates key payment systems, including those for check clearing and interbank transfers, and oversees private-sector payment systems. It also acts as the federal government's fiscal agent—federal receipts and payments flow through Treasury's accounts at the Fed.

Policy Issues

Congressional Oversight. Congress has delegated monetary policy to the Fed but conducts oversight to ensure the Fed meets its statutory mandate of "maximum employment, stable prices, and moderate long-term interest rates." The Fed has defined stable prices as a longer-run goal of 2% inflation. The Fed is expected to complete a review of its monetary policy strategy, tools, and communications in 2020.

The Fed is more independent from Congress and the Administration than most agencies. Economists have justified the Fed's independence on the grounds that monetary policy decisions that are insulated from short-term political pressures result in better economic outcomes. There is an inherent trade-off between independence and accountability, however.

Nevertheless, the Fed's independence has limits. Contrary to popular belief, the Government Accountability Office already audits the Fed upon congressional request, but it is prohibited by law from conducting economic analyses of monetary or lender-of-last-resort activities. The Fed is statutorily required to testify semiannually before and present a written report to the House Financial Services Committee and the Senate Banking, Housing, and Urban Affairs Committee. Congress has debated whether the Fed should report to it more frequently and in more detail. Congress has also debated what types of information the Fed should publicly disclose. Disclosure helps Congress and the public to better understand the Fed's actions. Up to a point, this makes monetary and regulatory policy more effective, but too much disclosure could make both less effective because they rely on market-sensitive and confidential information. The Dodd-Frank Act (P.L. 111-203) required the Fed to release information with a lag on the identities of all borrowers and the terms of borrowing.

Balance Sheet. Congress has conducted oversight of the Fed's balance sheet. The Fed has decided to continue using a new method for targeting interest rates that relies on maintaining a balance sheet more than four times larger than before the financial crisis and paying banks interest on the reserves they hold at the Fed. The Fed enlarged its balance sheet in 2019 and may take additional steps to stabilize the repo market. Congress has 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, and would do so again in multiple bills passed by the House in the 116th Congress.

Regulation. The Fed has recently been implementing *regulatory relief* for large and small banks on its own initiative and as required by P.L. 115-174. Finding the optimal trade-off between the benefits and costs of financial regulation continues to be debated. Congress has also been concerned about whether the Fed is susceptible to *regulatory capture*, the concept that regulated entities have undue influence over regulation.

Governance and Diversity. Congress has debated changes to the Fed's governance structure. Proposals include changing the voting balance between Fed governors and presidents on the FOMC; making the New York Fed president a presidential appointee; and changing how the regional bank directors and presidents are selected. Some Members of Congress have also expressed concern over a lack of diversity at the Fed. The Dodd-Frank Act created Offices of Minority and Women Inclusion for the Federal Reserve System. H.R. 281 would require diverse candidates to be interviewed when selecting Federal Reserve bank presidents. H.R. 974 would require the vice chair for supervision to provide written testimony and would require the chair to testify if the vice chair position is vacant.

Real Time Payments (RTP). In 2019, the Fed announced that it would create a RTP system to expedite bank-to-bank payment settlement. This system would compete with an existing RTP system owned by a group of large banks. Competition in RTP between the Fed and the private sector raises issues about cost to users, ubiquity, equity, innovation, interoperability, and security.

CRS Resources

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

CRS Report R42079, *Federal Reserve: Oversight and Disclosure Issues*, by Marc Labonte

CRS Report R45927, *U.S. Payment System Policy Issues: Faster Payments and Innovation*, by Cheryl R. Cooper, Marc Labonte, and David W. Perkins

Marc Labonte, Specialist in Macroeconomic Policy

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