



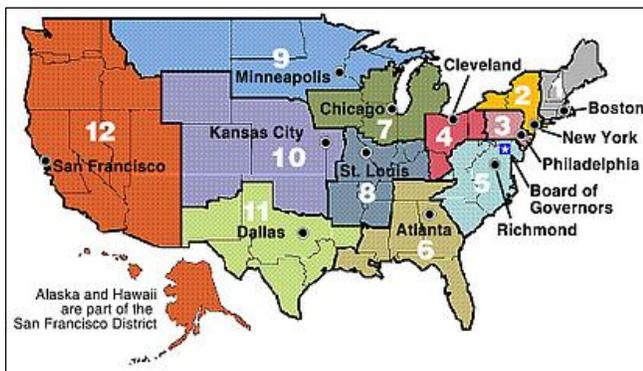
Introduction to Financial Services: The Federal Reserve

Structure of the Federal Reserve

The Federal Reserve Act of 1913 (12 U.S.C. 221 et seq.) created the Federal Reserve (Fed) as the nation's central bank. The Fed is composed of 12 regional Federal Reserve banks overseen by a Board of Governors in Washington, DC. **Figure 1** illustrates the city in which each bank is headquartered and the area of each bank's jurisdiction.

The board is composed of seven governors nominated by the President and confirmed by the Senate. The President selects (and the Senate confirms) a chair and two vice chairs from among the governors, one of whom is responsible for supervision. The governors serve nonrenewable 14-year terms; the chair and vice chairs serve renewable four-year terms. Board members are chosen without regard to political affiliation. Regional bank presidents are chosen by their boards with the approval of the Board of Governors.

Figure 1. Federal Reserve Districts



Source: Federal Reserve.

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

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

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

stock pays dividends of 6% for banks with less than \$10 billion in assets and the lower of 6% or the 10-year Treasury yield for banks with more than \$10 billion in assets. Member banks choose two-thirds of the boards at the regional Fed banks.

Responsibilities of the Federal Reserve

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

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

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

During the financial crisis, the Fed reduced the federal funds rate to zero and conducted large-scale asset purchases of Treasury- and mortgage-backed securities from 2008 to 2014—known as *quantitative easing (QE)*—that increased the size of its balance sheet. Following a period when rates rose and the balance sheet shrunk, the Fed began to cut rates and expand its balance sheet again in 2019. At the onset of the pandemic, the Fed swiftly lowered interest rates to zero and increased its use of QE and repos to boost liquidity. This caused the balance sheet to double in 18 months, which has boosted Fed remittances to the Treasury.

Lender of Last Resort. Despite their name, Federal Reserve banks do not carry out any banking activities, with

one limited exception: The Fed traditionally acts as lender of last resort by making short-term, collateralized loans to banks through its discount window. The Fed generally sets the *discount rate* charged for these loans above market rates. In normal market conditions, the Fed's lending operations are minimal. In crises, such as the 2008 financial crisis and COVID-19 pandemic, the Fed has created emergency facilities using emergency authority to extend its lender-of-last-resort function to nonbanks and markets.

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

Payment Systems. The Fed operates key payment systems, including check clearing and interbank transfers, and oversees some private-sector payment systems. The Fed is planning to launch FedNow, a real-time payment system for instantaneous payment settlement, in 2023. It also acts as the federal government's fiscal agent—federal receipts and payments flow through Treasury's accounts at the Fed.

Mandate and Congressional Oversight

Congress has delegated monetary policy to the Fed but conducts oversight to ensure the Fed meets its statutory mandate of “maximum employment, stable prices, and moderate long-term interest rates” (12 U.S.C. 225a). The Fed has defined stable prices as a longer-run goal of 2% inflation as measured by the personal consumer expenditures price index.

The Fed is more independent from Congress and the Administration than most agencies are. Economists have justified the Fed's independence on the grounds that monetary policy decisions that are insulated from short-term political pressures result in better economic outcomes. There is an inherent trade-off between independence and accountability, however. The chair and vice chair for supervision are statutorily required to testify semi-annually before the committees of jurisdiction, and the committees regularly conduct other hearings on the Fed (12 U.S.C. 225b and 247b).

Policy Issues

Monetary Policy and Inflation. Since 2021, inflation has risen to high levels last seen in the early 1980s. Before 2021, inflation was consistently low and stable. Concerned that the pandemic could undermine the recovery and initially viewing high inflation as transitory, the Fed waited until March 2022 to begin raising interest rates and to end its asset purchases. In June 2022, the Fed began gradually reducing its balance sheet. Playing catch up, the Fed raised rates aggressively in 2022 and still expects additional rate

hikes will be needed to restore low inflation. Some critics question whether the hikes will be sufficient to reduce inflation, while others fear that the hikes will cause a recession.

Diversity. Some Members of Congress have expressed concern over a lack of diversity at the Fed and in the banking sector and believe that the Fed could do more to eliminate racial disparities. The Dodd-Frank Act (P.L. 111-203) created Offices of Minority and Women Inclusion for the Federal Reserve System. Bills in the 117th Congress would have required the Fed to exercise its duties to foster the elimination of (and testify on its efforts to eliminate) racial disparities and would have required the Fed (and other bank regulators) to include diversity in their supervisory ratings of banks.

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

Climate Change. In 2020, the Fed joined the intergovernmental Network for Greening the Financial System. In 2021, the Fed created two internal committees related to climate risk. In 2022, the Fed announced the six largest banks would participate in a climate scenario analysis to quantify their exposure to climate risk. Some critics believe the Fed should be doing more to combat climate change, such as “stress tests” linking capital requirements to climate exposure. Other critics believe that climate change is outside of the Fed's mission and the Fed lacks the tools to effectively address it.

Regulation. The optimal tradeoff between the benefits and costs of financial regulation continues to be debated, with banks arguing that they face too much regulatory burden, disadvantaging them compared to nonbank competitors. Many in Congress have expressed concern about whether the Fed is susceptible to *regulatory capture*, the concept that regulated entities have undue influence over regulation.

CRS Resources

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

CRS In Focus IF12147, *The Federal Reserve's Balance Sheet and Quantitative Easing*

CRS Report R47273, *Inflation in the U.S. Economy: Causes and Policy Options*

CRS Report R46850, *Central Bank Digital Currencies: Policy Issues*

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