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Federal Reserve: Policy Issues in the 118th Congress

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SUMMARY

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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 payment systems, and lender of last resort. This report summarizes policy issues for Congress in each of these areas.

Monetary policy. The Fed has a statutory mandate of maximum employment and price stability. The Fed conducts monetary policy by targeting the federal funds rate, a short-term interest rate. The Fed has been raising interest rates since March 2022 in an effort to reduce inflation, which has run well above the Fed's 2% inflation target since 2021. 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 reducing its size. Congress has debated whether the Fed has acted aggressively enough to reduce inflation and its balance sheet or, alternatively, whether the Fed's actions will result in a recession. The Fed's inability to maintain low inflation has recently led some to question whether its dual mandate—or its monetary policy strategy for achieving its mandate—should be altered. The Fed remits its net income to the Treasury, and higher interest rates may cause remittances to temporarily fall to zero in the coming years.

Regulation. The Fed regulates bank holding companies, some state-chartered banks, and some U.S. operations of foreign banks. The Fed's current regulatory priorities—managing climate risk, a holistic review of capital requirements, the merger approval process, Community Reinvestment Act modernization, and crypto services offered by banks—are of interest to Congress.

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 operators. Banks directly access Fed payment systems through master accounts at the Fed. Policymakers have debated to what extent fintech and crypto firms should be granted master accounts. In the 117th Congress, the National Defense and Authorization Act for FY2023 (P.L. 117-263) required the Fed to publicly release a list of master account holders. Congress has also debated whether the Fed should introduce a central bank digital currency (or "digital dollar") and whether the Fed should regulate payment stablecoins.

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 used this power to create emergency facilities to support the financial system during the pandemic. Congress took the unprecedented step of providing at least $454 billion and up to $500 billion to the Treasury to support Fed programs through the Coronavirus Aid, Relief, and Economic Security Act (CARES Act, P.L. 116-136). As financial conditions improved rapidly—faster than the economy improved—take up for the programs turned out to be much smaller than their announced size. The emergency programs backed by the CARES Act expired at the end of 2020, while most other emergency programs were extended until March 2021. P.L. 116-260 prohibited the Fed from reopening CARES Act–backed programs for corporate bonds, municipal debt, and the Main Street Lending Program.

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.

Congress has also debated how to promote diversity and inclusion within the Fed and the banking system. In the 117th Congress, the House passed the Federal Reserve Racial and Economic Equity Act (H.R. 2543).

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Introduction

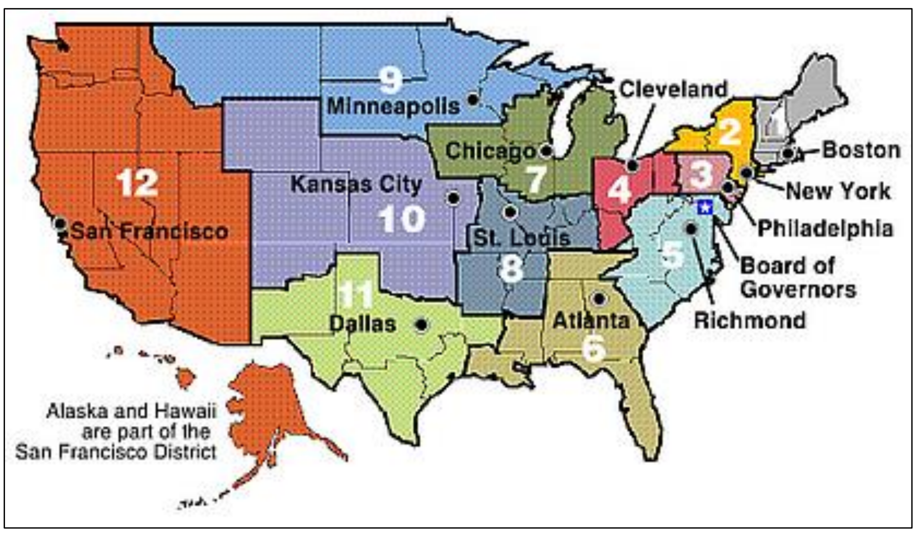
The Federal Reserve Act of 1913 (12 U.S.C. §§221 et seq.) created the Federal Reserve (Fed) as the nation's central bank. The Fed's responsibilities fall into four main categories: monetary policy, regulation of certain banks and other financial firms, provision and oversight of certain payment systems, 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 background and discusses current policy issues in each of those four areas, as well as oversight and diversity.

The Fed's powers and mission have evolved since its creation. Its independence gives its latitude to act quickly and decisively. For that reason, 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 tradeoffs, 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.

Structure

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, which were more effectively carried out if centralized, led to a series of early reforms to make the system more centralized.[1] Tension between competing desires for a centralized and decentralized system are at the root of some policy proposals to change the Fed's structure.

Figure 1. Federal Reserve Districts



Source: Federal Reserve.

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

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 governor from any of the 12 Federal Reserve districts. One of the governors must have "primary experience working in or supervising community banks." The President selects (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. Board members are chosen without regard to political affiliation, unlike many other federal regulators and independent agencies. Regional bank presidents are chosen by their boards with the approval of the Board of Governors.

In general, policy is formulated by the Board of Governors 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 is chaired by the Fed chair.

The Fed's budget is not subject to the congressional appropriation or authorization process. The Fed is funded by fees paid by financial institutions that use its services and the income generated by securities it owns. As discussed below,[2] its income exceeds its expenses, and it remits most of its net income to the Treasury, where it is added to general revenues and used to reduce the federal debt. By statute, the Consumer Financial Protection Bureau (CFPB) is funded by a transfer from the Fed set by the director of the CFPB. An appeals court recently ruled that this funding mechanism is unconstitutional, and the CFPB has appealed the decision.[3]

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.[4]) 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. 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) and the lower of 6% or the 10-year Treasury yield for banks with more than $10 billion in assets.

Policy issues for Congress going forward include the following:

- 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?

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[2] See the section entitled "What If the Fed Suffered Losses on Its Balance Sheet?"

[3] For more information, see CRS Legal Sidebar LSB10847, *Congressional Court Watcher: Recent Appellate Decisions of Interest to Lawmakers (Oct. 17–Oct. 23, 2022)*, by Michael John Garcia and Caitlain Devereaux Lewis.

[4] 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.

- Is ownership of the Fed by the banks that it regulates appropriate, given the inherent conflict of interest in such an arrangement? Or are current safeguards sufficient?
- Should the CFPB have its own funding source or, pending outstanding litigation, 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 seats on the board be set aside for other interest groups besides community banks? Or 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.

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 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 percent change in the Personal Consumption Expenditures (PCE) price index.

As mentioned, 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 federal funds rate (FFR), the overnight interest rate in the federal funds market, a private market where banks lend to each other. The FOMC 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 practice, and it seems to change over time.[5] The Fed chooses whether 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

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

residential investment (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.[6] 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.[7] 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.

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

The Post-Financial Crisis 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 (IOR) and by using reverse repurchase agreements (repos) to drain liquidity from the financial system. It received statutory authority to pay interest on reserves in 2008.[8] 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.

[6] 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 Board of Governors of the Federal Reserve System, "Policy Tools," https://www.federalreserve.gov/monetarypolicy/openmarket.htm.

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

[8] 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.

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, because banks will generally deploy their surplus reserves to earn whichever rate is more attractive.[9]

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.[10] 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. 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. (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 by banks.

After the Fed ended QE in 2014, it decided to maintain abundant reserves instead of fully shrinking its balance sheet and returning to its pre-crisis 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. In 2021, the Fed added a standing repo facility to make it easier to keep the FFR from exceeding its target. The repo and reverse repo facilities, which fundamentally altered the functioning of a private lending market (by shifting from an ad hoc to permanent Fed backstop in the market), were created using existing authority without new legislation or notice-and-comment rulemaking.

High Inflation and Higher Interest Rates[11]

The primary focus of monetary policy is currently on reducing high inflation. After decades of low inflation, inflation has been above the Fed's 2% target since March 2021. Since October 2021, PCE inflation (measured as the 12-month change) has exceeded 5%, its highest level in decades. High inflation originated in a number of factors, such as supply chain disruptions and high commodity prices following the Russian invasion of Ukraine. But regardless of why inflation is high, it can be reduced through policies that reduce demand or increase supply. Out of the various options to do so, monetary policy is viewed as the one that can reduce inflation most quickly and forcefully, in practice, and so mainstream economists view the ability to effectively reduce inflation to lay primarily with the Fed. In the words of Fed Chair Jerome Powell, "The

[9] The interest rate on reserves might be expected to set a floor on the FFR, but in practice the actual FFR was slightly lower than the interest rate on reserves when the Fed began paying interest from 2008 until 2019. 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.

[10] 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 changed to immediately in the Emergency Economic Stabilization Act of 2008 (P.L. 110-343).

[11] This section draws from other CRS products co-authored with Lida Weinstock.

first lesson [from the history of inflation] is that central banks can and should take responsibility for delivering low and stable inflation."[12]

By historical standards, the Fed provided a magnitude of monetary stimulus in response to the COVID-19 pandemic that was matched only during the 2007-2009 financial crisis. This stimulus included reducing the FFR to effectively zero and purchasing trillions of dollars of securities, as discussed in the next section. Despite higher inflation since 2021, the Fed left this stimulus in place until March 2022. Fed leadership (and other policymakers) assumed that the initial increase in inflation in 2021 was transitory and decided to leave monetary stimulus in place to guard against the economic recovery becoming derailed by the ongoing threat of the pandemic. In hindsight, inflation proved to be a bigger threat than a lackluster recovery, but decades of sustained low inflation—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 was higher, more widespread, and more deeply embedded.

The Fed changed course in 2022, raising rates repeatedly and rapidly following each FOMC meeting since March and beginning a gradual reduction of the balance sheet in June.[13] Nevertheless, the wait-and-see approach to tightening means that monetary policy continues to be stimulative overall despite the significant withdrawal of stimulus that occurred in 2022. For example, interest rates remained negative in real terms in 2022, meaning they were lower than the inflation rate, so borrowing costs were still low once inflation is taken into account. To date, there is not evidence that low inflation is being restored. Thus far, the Fed has indicated that it will continue to raise rates until it feels assured that inflation will return to its 2% target.

The Fed is hoping for a "soft landing," where inflation falls without triggering a recession. But the Fed's current policy faces upside and downside risks. The downside risk is a "hard landing" scenario where higher interest rates move the economy back into a recession if interest-sensitive spending and net exports fall enough that overall spending declines and unemployment rises. Barring new supply side shocks, inflation is likely to fall if the economy does enter a recession, but recessions come with their own costs. The upside risk is that high inflation has become deeply embedded in people's expectations, making it difficult to reduce, and the Fed is unwilling to raise rates enough to bring inflation down. This may avoid a recession in the short run but could eventually result in a "stagflation" scenario, where inflation remains high and is relatively unresponsive to changes in the unemployment rate, as occurred in the 1970s.[14]

High inflation has been an issue of congressional focus since 2021. Policy issues going forward include the following:

- Can the Fed successfully reduce inflation and restore price stability? If so, how quickly?
- How much more would interest rates need to rise in order for that to occur? How will higher interest rates affect U.S. businesses and households?
- Can the Fed reduce inflation without causing a recession? If the economy enters a recession before inflation has returned to 2%, how should the Fed respond?

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

[13] The Fed can mitigate inflationary pressures by raising interest rates and 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 rate changes and not based its balance sheet reduction plans on the inflation rate.

[14] For more information, see CRS Insight IN11963, *Where Is the U.S. Economy Headed: Soft Landing, Hard Landing, or Stagflation?*, by Marc Labonte and Lida R. Weinstock.

- At what rate would tolerating higher inflation rate be preferable to policies that might result in higher unemployment?
- Could price stability be restored more quickly if monetary tightening is accompanied by additional fiscal tightening or policies to tackle supply side constraints? If the Fed is unable to achieve its inflation target without causing a recession, should there be a fiscal policy response?

For more information, see CRS Report R47273, *Inflation in the U.S. Economy: Causes and Policy Options*, by Marc Labonte and Lida R. Weinstock.

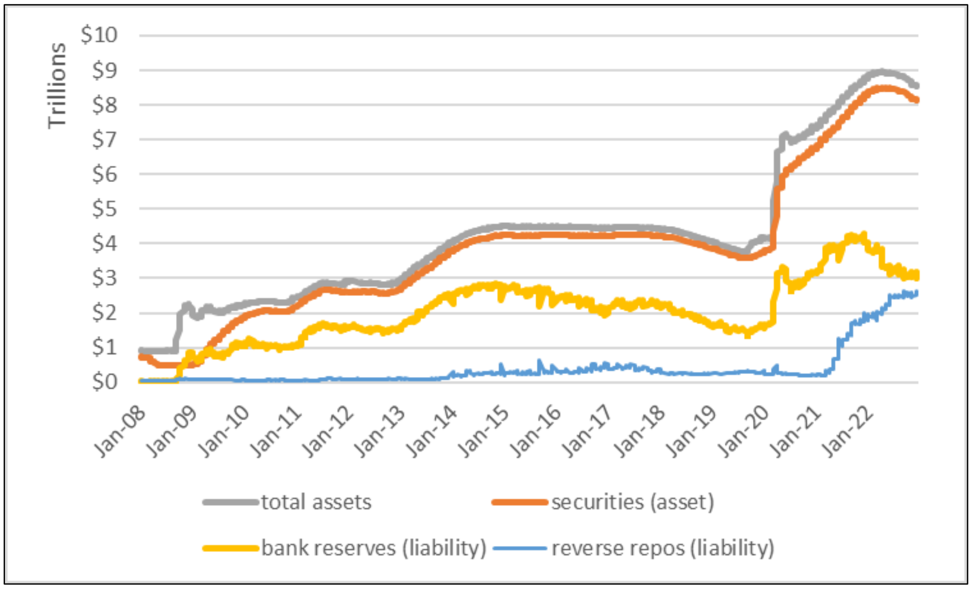
Normalizing the Fed's Balance Sheet

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 and repos entered into through its Standing Repo Facility.[15] Its assets also include loans and other assets acquired from the discount window and other emergency facilities. Its liabilities are primarily currency, reverse repos, bank reserves held in master accounts at the Fed, and balances that Treasury holds at the Fed.[16] 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 2**.

[15] 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.

[16] Reserves are assets held as liquid cash balances, as opposed to funds invested in loans or securities. Banks were subject to minimum reserve requirements until 2020, when the Fed removed them. Their removal is related to the shift to the "abundant reserves" monetary framework discussed above. 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.

Figure 2. Selected Assets and Liabilities on Fed's Balance Sheet, 2008-2022



Source: Federal Reserve.

Notes: Click and type notes

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 serious 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 QE, it purchased trillions of dollars of primarily Treasury securities and MBS in an effort to directly lower their yield.[17] As a result, the Fed's balance sheet grew significantly in three rounds of purchases from 2008 to 2014 and then again in purchases made from 2020 to 2022, as shown in **Table 1**. The Federal Reserve's balance sheet expanded from $4.7 trillion on March 19, 2020, to $7 trillion on May 20, 2020, to a high of almost $9 trillion in May 2022.[18] 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. About $3.4 trillion of its liabilities were held in bank reserves and $2.2 trillion in reverse repos. At its peak, the balance sheet was around 10 times larger than it was before the 2008 financial crisis.

Table 1. Federal Reserve Balance Sheet Trends

Trillions of Dollars, 2008-2022

Event (Dates of Balance Sheet Changes)	End Size	Change
Financial Crisis (9/08-12/08)	$2.2	+$1.3

[17] 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.

[18] 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.

Event (Dates of Balance Sheet Changes)	End Size	Change
QE1 (3/09-5/10)	$2.3	+$0.4
QE2 (11/10-7/11)	$2.9	+$0.6
QE3 (10/12-10/14)	$4.5	+$1.7
Roll Off (9/17-8/19)	$3.8	-$0.7
Repo Turmoil (9/19-2/20)	$4.2	+$0.4
COVID-19 (3/20-5/22)	$8.9	+$4.8

Source: CRS calculations based on Federal Reserve data.

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.[19] (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 the 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 purchases in November 2021 (i.e., reduced the growth rate of the balance sheet), ended its purchases in March 2022 (i.e., kept the size of the balance sheet steady), 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. Now that the wind down is fully phased in, the Fed is allowing up to $60 billion in Treasury securities and $35 billion in MBS to roll off every month. If more securities mature than the caps in a given month, the Fed will purchase assets to replace the excess amount.[20] The Fed has no plans to sell securities currently.

In statements in January and May 2022, the Fed laid out its long-term goals for the balance sheet.[21] 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, consistent with its "ample reserves" framework for monetary policy,[22] 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."

Policy issues for Congress going forward include the following:

- Does the Fed's large holdings of Treasury securities compromise its independence by making it more susceptible to subordinating monetary policy by providing low-cost financing of the federal debt? Do the Fed's holdings (and its effect on Treasury yields) make it more attractive to Congress and the Administration to increase the federal debt?

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[19] When the price of a debt security rises, its effective yield falls. This alters interest rates on new debt.

[20] 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.

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

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

- 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?
- 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 doing so lead to the Fed having a permanently outsized presence in repo markets?
- Have the Fed's MBS purchases contributed to making house prices out of reach for first-time buyers by contributing to low mortgage rates during the pandemic? 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?
- Will the aftermath of QE result in losses to the Fed that temporarily halt remittances to Treasury (as discussed in the next section)?

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

What If the Fed Suffered Losses on Its Balance Sheet?

The Fed earns income on its loans, repos, and securities, 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. Net income is used exclusively to (1) pay statutorily required dividends to shareholders and (2) increase the surplus when it is below its statutory cap. The remainder is transferred to the Treasury (called remittances), where they are added to the federal government's general revenues. Since remittances cannot be used to fund federal spending, they effectively make the budget deficit and federal debt smaller than they otherwise would be.

Since 1935, the Fed has remitted revenue to Treasury annually.[23] Beginning in 2009, its net income and remittances have increased significantly as a result of its balance sheet growth and low short-term interest rates. Prior to that year, the largest annual remittances ever were $35 billion. Between 2009 and 2021, annual remittances have been between $47 billion and $117 billion each year.

It is possible that the Fed could have negative net income if its expenses exceeded its income in the future. Although this has not happened to date, it could happen if the interest rate it pays on bank reserves and reverse repos became higher than the yield on the securities it holds.[24] If the Fed's net income became negative, it would temporarily stop remitting funds to the Treasury. Partly because of the statutory limit on its surplus, the Fed holds very little capital relative to its

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[23] In some years, remittances were statutorily required. In years with no statutory requirement, remittances were the result of positive net income less dividends and additions to the Fed's surplus. Federal Reserve *Annual Report, 2021*, Table G.10, https://www.federalreserve.gov/publications/files/2021-annual-report.pdf.

[24] 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 securities to maturity, the chance that these securities will suffer losses is negligible.

liabilities. But unlike a private company, under the Fed's accounting conventions it would not reduce its capital, become insolvent, or require a capital infusion to maintain solvency in response to losses. Instead, it would register the losses as a deferred asset. Profits in future years would be directed to eliminating this deferred asset instead of being remitted to Treasury. Unlike a private company, the Fed cannot be compelled by its creditors to declare bankruptcy.

Recent projections point to the possibility that the Fed might temporarily experience losses in the near future because the Fed acquired large holdings of low yielding assets during the pandemic and interest rates rose sharply in 2022, causing the Fed's interest expenses to rise sharply. Typically, longer-term assets usually have higher yields than very short-term liabilities do. An unusual, but plausible, scenario in the current environment is that interest rates will continue to rise to the point where interest rates on the Fed's short-term liabilities are higher than the rates on their long-term assets. In this scenario, the yield on the Fed's assets would eventually exceed the yield on its liabilities again, making net income and remittances positive again.

Three recent studies find mixed evidence that net income will become negative and remittances will fall to zero. However, all three used lower interest rate assumptions than actual rates have turned out to be in 2022. Therefore, they probably overestimate net income in the next few years, assuming interest rates remain higher.

- The New York Fed, which manages the Fed's securities and implements monetary policy, projected that net income (and hence remittances) would remain positive through 2030 in its baseline projection. But in an alternative projection with higher interest rates, net income would be negative from 2023 to 2024 or 2025, depending on underlying assumptions. Both the baseline and alternative projections assume lower interest rates than actual rates in 2022.[25]
- Federal Reserve Board economists found that remittances would be zero from 2023 to 2025 in their baseline projection. Net income would be positive again in 2025 but would be used to reduce the deferred asset associated with prior losses rather than be remitted to Treasury. From 2026 to the end of the projection, remittances would be positive again. Under alternative scenarios, remittances would be zero only in 2023 or could be zero until as late as 2028, but in none of their scenarios would remittances remain positive throughout the projection. The federal funds rate in 2022 in their baseline scenario is lower than actual rates. Actual rates are closer to an alternate scenario where remittances cease for longer.[26]
- The Congressional Budget Office projected that net income and remittances will decline but remain positive throughout its 10-year projection. However, this estimate used interest rate projection for 2022 that are lower than actual interest rates turned out to be.[27]

[25] Federal Reserve Bank of New York, *Open Markets Operations During 2021*, May 2022, p. 48, https://www.newyorkfed.org/medialibrary/media/markets/omo/omo2021-pdf.pdf.

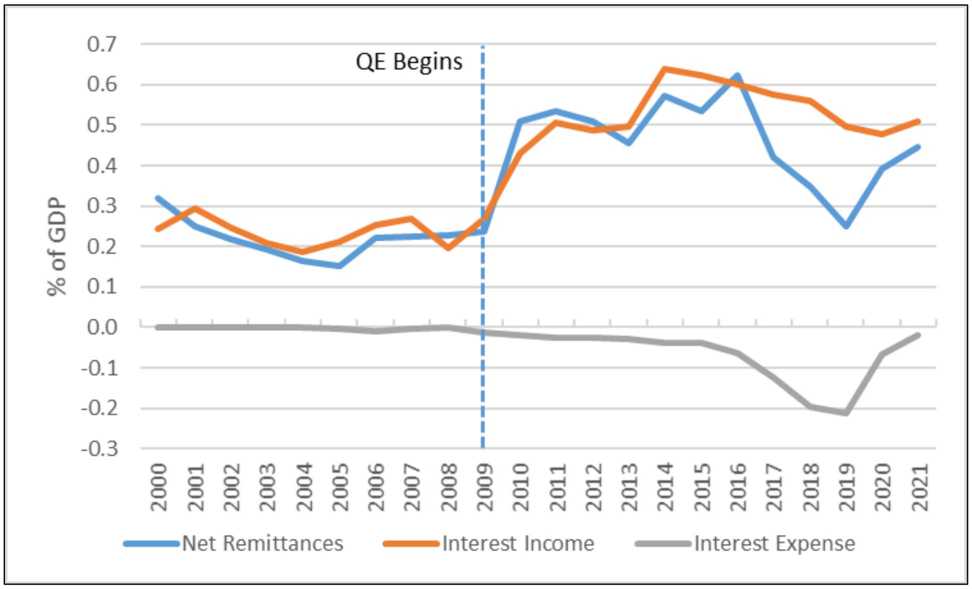
[26] Alyssa Anderson et al, An Analysis of the Interest Rate Risk of the Federal Reserve's Balance Sheet, Part 2: Projections Under Alternative Interest Rate Paths, Federal Reserve, July 15, 2022, https://www.federalreserve.gov/econres/notes/feds-notes/an-analysis-of-the-interest-rate-risk-of-the-federal-reserves-balance-sheet-part-2-20220715.html.

[27] Congressional Budget Office, *How the Federal Reserve's Quantitative Easing Affects the Federal Budget*, September 8, 2022, https://www.cbo.gov/system/files/2022-09/57519-balance-sheet.pdf.

The Fed is not a profit maximizing institution—its remittances are a byproduct of monetary policy, not the metric by which the success of monetary policy is judged. Losses would not be a sign of mismanagement but a sign that its interest-bearing liabilities had a higher yield than its interest-bearing assets did. If the Fed based monetary policy on concerns about its profits and losses, it would detract from achieving the statutory mandate.[28] Any temporary losses in future years would be expected to be more than offset by the unusually large remittances the Fed has made annually since 2009 as a result of QE (see **Figure 3**.) Moreover, this considers only the direct effect of QE on the federal budget. If QE returned the economy to full employment faster in prior years, that also had a positive indirect effect on the federal budget. Nevertheless, there might be political implications—notably for its independence—if the Fed experienced losses.

Figure 3. Fed Interest Income and Expenses and Net Remittances

2000-2021



Source: Congressional Budget Office, *How the Federal Reserve's Quantitative Easing Affects the Federal Budget*, September 8, 2022, Figure 5, https://www.cbo.gov/system/files/2022-09/57519-balance-sheet.pdf.

Notes: Interest income equals income from Treasury securities and MBS. Interest expense equals interest paid on reserves plus interest on reverse repos less interest on repos. Remittances are net of all income and expenses less capital distributions, whereas the figure shows only interest income and expenses.

Policy issues going forward include the following:

- Should the Fed reconsider how it conducts QE to reduce the possibility that future episodes of balance sheet expansion would result in losses (e.g., by purchasing short-term instead of long-term securities)?
- If the Fed were to suffer losses, would it undermine its independence from Congress and the President? Would it undermine market confidence or financial stability?

[28] Replacing the ample reserves framework with the scarce reserves framework used before the crisis could reduce the potential for losses if the Fed then eliminated interest on reserves and the reverse repo facility. To date, Congress has deferred to the Fed on choosing a framework, however.

- Should Congress raise the statutory limit on the Fed's surplus to increase the Fed's capital stock if it is concerned about these outcomes? Alternatively, should Congress eliminate the surplus entirely to avoid further use of the surplus as a "pay for" for unrelated policy changes?[29]

Mandate Reform and Monetary Policy Strategy

Until 2012, the Fed did not have an inflation target, meaning it did not provide guidance on how it interpreted these goals 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 percent 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 two-year *Review of Monetary Policy Strategy, Tools, and Communications*, the FOMC announced on August 27, 2020, revisions to its *Statement on Longer-Run Goals and Monetary Policy Strategy*.[30] 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 early 2021. It emphasized changes in strategy to make this less likely in the future, including (1) advocating periods of above-target inflation to follow periods of below-target inflation and, (2) assuming inflation is low, pledging to lower rates when unemployment is high but not to raise rates when unemployment is low. Since 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.[31]

The Fed's dual mandate provides the Fed with discretion on how to interpret 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 high, 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 they do while providing the Fed maximum discretion to decide how to respond.

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[29] Previous efforts by Congress to prohibit the use of the surplus as a 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 an offset.

[30] 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.

[31] 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 otherwise would 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.

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. The Fed had been very successful at delivering low and stable inflation over the past four decades—until 2021. Whether it or external forces are to blame for intermittent periods where maximum employment was not achieved during that time is debatable. 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.[32] Others believe that full employment should get more weight and price stability less.[33] 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 case, international comparisons suggest that central banks are likely to react to changes in both unemployment and inflation, regardless of their mandate.

Independent of their mandate type, 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 2% target is too low, while others believe it is too high. Some economists believe a nominal GDP target or some form of price level targeting would work better than an inflation target. Other economists argue that discretionary monetary policy should be replaced or reduced by a focus on monetary policy rules[34]—that is, mathematical formulas that prescribe how interest rates should be set on a limited number of economic variables, such as the output gap and inflation. 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 type of changes are desirable, the Fed could pursue them internally, or Congress could impose them through legislation.

Policy issues for Congress going forward 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 current period of high inflation strengthened the case for a single mandate of price stability? Should the 2020 changes to the Fed's monetary policy strategy, intended to address excessively low inflation, be reversed in light of current high inflation?
- 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? Would another measure such as a nominal GDP target, a price level

[32] 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/.

[33] 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.

[34] Sometimes monetary policy rules are called Taylor rules after the creator of an early rule, economist John Taylor.

target, or a policy rule be more effective, or would those measures needlessly complicate monetary policymaking and transparency?

For more information, see CRS Insight IN11499, *The Federal Reserve's Revised Monetary Policy Strategy Statement*, by Marc Labonte, CRS In Focus IF10207, *Monetary Policy and the Taylor Rule*, by Marc Labonte, and CRS Report R41656, *Changing the Federal Reserve's Mandate: An Economic Analysis*, by Marc Labonte.

Bank Regulation

The Fed supervises bank holding companies (BHCs) and thrift holding companies—parent companies that own nearly all large and most small depositories as subsidiaries—for safety and soundness.[35] The Fed is also the primary prudential regulator of most types of U.S. operations of foreign banking organizations and state-chartered banks that have elected to become members of the Federal Reserve System. Often in concert with the other banking regulators,[36] 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 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.[37]

The Fed has also historically had a focus on maintaining financial stability, which since the Dodd-Frank Act has been the primary responsibility of the Financial Stability Oversight Council (FSOC), with certain new duties assigned to the Fed.[38] For example, the Dodd-Frank Act, as amended by the Economic Growth, Regulatory Relief, and Consumer Protection Act (P.L. 115-174), subjects BHCs with more than $250 billion in consolidated assets and nonbank financial firms designated by FSOC as systemically important financial institutions (SIFIs) to enhanced prudential regulation (i.e., stricter standards than are applied to similar firms) administered by the Fed in an effort to mitigate the systemic risk they pose.[39] Since enactment, the number of designated nonbank firms has ranged from four to none today.[40]

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

[35] 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.

[36] The federal banking regulatory system is charter based. Federally chartered banks are regulated by the Office of the Comptroller of the Currency (OCC), and state-chartered banks that do not join the Federal Reserve System are regulated by the Federal Deposit Insurance Corporation (FDIC). 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.

[37] 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.

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

[39] For more information, see CRS Report R42150, *Systemically Important or "Too Big to Fail" Financial Institutions*, by Marc Labonte.

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

Financial Stability Board and the Basel Committee on Banking Supervision (BCBS), alongside other U.S. agencies.

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. Current regulatory issues of interest to Congress include climate change, large banks, Community Reinvestment Act modernization, bank mergers, banking services to cannabis firms, and cryptocurrency services. Some issues involve the Fed acting alone, and some involve it acting jointly with other banking regulators.

Climate Change

The Fed has increased its focus on financial and economic risks posed by climate change in recent years. In 2020, the Fed joined the Network for Greening the Financial System, a group of over 80 central banks and regulators focused on climate-related risks. In 2021, the Fed created two internal committees related to climate risk.

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 believes its guidance on managing risk from extreme weather events is well equipped for managing an increase in extreme weather events caused by climate change.[41] In December 2022, the Fed requested comments on "draft principles that would provide a high-level framework for the safe and sound management of exposures to climate-related financial risks for financial institutions with over $100 billion in assets." The Fed stated that it intended to coordinate any final guidance with the Office of the Comptroller of the Currency (OCC) and FDIC, which had earlier requested comment on similar draft principles.[42]

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. In September 2022, the Fed announced that the six largest banks would participate in a pilot "climate scenario analysis" to "help identify potential risks and promote risk management practices."[43] This exercise would not have any implications for capital requirements or supervision. Results are scheduled for the end of 2023.

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 FSOC report, which the Fed is a member of, identified climate change as an emerging and increasing

[41] 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.

[42] Federal Reserve, "Federal Reserve Board Invites Public Comment on Proposed Principles Providing a High-Level Framework for the Safe and Sound Management of Exposures to Climate-Related Financial Risks for Large Banking Organizations," press release, December 2, 2022, https://www.federalreserve.gov/newsevents/pressreleases/files/other20221202b1.pdf

[43] Federal Reserve, "Federal Reserve Board Announces That Six of the Nation's Largest Banks Will Participate in a Pilot Climate Scenario Analysis Exercise Designed to Enhance the Ability of Supervisors and Firms to Measure and Manage Climate-Related Financial Risks," press release, September 29, 2022, https://www.federalreserve.gov/newsevents/pressreleases/other20220929a.htm.

threat to financial stability and made a number of recommendations for agency actions, which include the actions the Fed has taken to date.[44] 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.

Policy issues for Congress going forward include:

- Should the Fed be doing more to combat climate change? Or is climate change 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?
- 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?

For more information, see CRS Insight IN11545, *How Do Bank Regulators Treat Climate Change Risks?*, by Rena S. Miller.

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 through a new enhanced prudential regulatory (EPR) regime that applies to large banks and to nonbank financial institutions designated by FSOC as SIFIs. (As noted above, currently there are no nonbank SIFIs.[45])

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:

- **Stress tests and capital planning** ensure that banks hold enough capital to survive a crisis.
- **Living wills** provide plans to safely wind down failing banks.
- **Liquidity requirements** ensure that banks are sufficiently liquid if they lose access to funding markets.
- **Counterparty limits** restrict banks' exposure to counterparty default.

[44] 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.

[45] Title II of Dodd-Frank aimed to end TBTF by creating an Orderly Liquidation Authority (OLA) to resolve nonbank financial firms, including nonbank subsidiaries of BHCs whose failure poses a threat to financial stability. It is administered by the FDIC and modelled on the FDIC's resolution authority. The Fed and the FDIC would jointly determine whether a firm should be liquidated under OLA. To date, OLA has never been used.

- **Risk management** requires 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** under Basel III, an international agreement, require large banks to hold more capital than other banks to potentially absorb unforeseen losses.

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, 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. Banks that have been designated as global systemically important banks (G-SIBs) by the Financial Stability Board or 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. Under the Federal Reserve's implementing rules, large banks are placed in one of four categories based on their size and complexity, and progressively more stringent requirements are imposed on them.[46] The rule also applied EPR to foreign banks with large U.S. operations and large savings and loan (thrift) holding companies that are not predominantly engaged in insurance or nonfinancial activities.[47]

Holistic Capital Review

Fed Vice Chair for Supervision Michael Barr has described a "holistic review of capital standards" that is currently underway.[48] Although not limited to large banks, the review is expected to focus on a number of capital standards that apply only to large banks. For example, the review is considering changes to the Supplementary Leverage Ratio (SLR), stress tests, resolution, and how to implement the Basel III Endgame.

SLR

Leverage ratios require banks to hold an amount of capital based on their total assets irrespective of the riskiness of those assets. (This stands in contrast to risk-based capital ratios, which require less or no capital to be held against safe assets.) Very large banks are subject to an SLR equal to

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[46] 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, 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, 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.

[47] 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.

[48] Vice Chair for Supervision Michael S. Barr, "Why Bank Capital Matters," speech at the American Enterprise Institute, Washington, DC, December 1, 2022, https://www.federalreserve.gov/newsevents/speech/barr20221201a.htm.

3% of their total assets and off-balance sheet exposures. G-SIBs are subject to a higher, enhanced SLR (5% at the holding company level and 6% for depository subsidiaries), called the eSLR. Regulators responded to the surge in banks' holdings of safe assets during the pandemic with a temporary exemption from the SLR for banks' reserve balances held at the Fed and their holdings of Treasury securities.

Regulators allowed this exemption to expire at the end of March 2021, by which time financial conditions had normalized. However, some regulators have suggested that a permanent change would be desirable to address the underlying issue of leverage ratios becoming dominant, thus undermining the principle that capital requirements be based on risk.

Leverage ratios are intended to be backstops to ensure a minimum level of capital adequacy, not a binding constraint on banks. However, according to then-Fed Vice Chair Randal Quarles, the rapid increase in safe assets on bank balance sheets during the pandemic caused the SLR to increasingly become the binding constraint for large banks.[49] Quarles decried the "perverse incentives" of a binding SLR to cause banks to want to avoid adding safe assets to their balance sheets. He argues that the SLR should be recalibrated to reflect a financial system with more Treasuries and bank reserves so that risk-weighted measures would again be the binding restraint, which would allow capital to be better aligned with risk.

One option is to finalize a 2018 proposed rule (which has not been finalized, to date) to link eSLR levels to a G-SIB's capital surcharge, which would effectively lower the eSLR.[50] Another option is to exempt selected safe assets from the SLR, which P.L. 115-174 did for custody banks. The drawback to the latter proposal is that the SLR would no longer play its role as a strictly neutral measure of capital adequacy. Although holders of Treasury securities do not face credit risk, they do face interest rate risk that could result in losses. It could also lead to a "slippery slope" dynamic, where if some assets were exempted, arguments would then be made that slightly riskier assets should also be exempted.[51] Exempting assets would result in either lower capital requirements for large banks or raising the SLR to avoid that result.

Stress Tests

In 2020, the Fed introduced the stress capital buffer, which reduced and simplified capital requirements for large banks by tying annual capital requirements to stress test results. For large banks, stress tests are the most important factor changing how much capital they must hold from year to year. Vice Chair Barr stated that the holistic capital review is considering whether incorporating a wider range of risks into stress tests would increase their usefulness.

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[49] Call reports do not report which capital requirement is the binding one, so this cannot be easily verified. Federal Reserve Vice Chair for Supervision Randal K. Quarles, "Between the Hither and the Farther Shore: Thoughts on Unfinished Business," speech, December 2, 2021, https://www.federalreserve.gov/newsevents/speech/quarles20211202a.htm. The increase in safe assets during the pandemic was the byproduct of the increase in bank deposits. See Andrew Castro, Michele Cavallo, and Rebecca Zarutskie, *Understanding Bank Deposit Growth During the COVID-19 Pandemic*, Federal Reserve, June 3, 2022, https://www.federalreserve.gov/econres/notes/feds-notes/understanding-bank-deposit-growth-during-the-covid-19-pandemic-20220603.htm.

[50] OCC, Federal Reserve, "Regulatory Capital Rules," 83 *Federal Register* 76, April 19, 2018, https://www.govinfo.gov/content/pkg/FR-2018-04-19/pdf/2018-08066.pdf. The BCBS leverage buffer proposal includes off-balance sheet items, consistent with the SLR. See BCBS, *Basel III: Finalising Post-Crisis Reforms*, December 2017, p. 143, https://www.bis.org/bcbs/publ/d424.pdf.

[51] Federal Reserve Governor Daniel K. Tarullo, "Departing Thoughts," speech, April 4, 2017, https://www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm.

Resolution

When banks fail, they enter an FDIC resolution process instead of the bankruptcy process. Avoiding government bailouts of large banks requires greater advance planning to ensure that if a large bank were to fail, it is structured so that it can be resolved safely. G-SIBs are subject to total loss-absorbing capacity (TLAC) requirements to reduce the likelihood of government bailouts by ensuring that equity and bondholders are positioned to be "bailed in" after a failure. On October 14, 2022, the Fed and FDIC released an advanced notice of proposed rulemaking on whether TLAC and other resolution requirements, such as a "clean holding company" requirement, should apply to a greater set of large banks.[52] In September 2022, the Fed and FDIC announced forthcoming proposed guidance modifying resolution plans.[53]

Policy issues going forward include the following:

- Have recent changes to EPR better tailored EPR to match the risks posed by large banks? Or have the additional systemic and prudential risks posed by these changes outweighed the benefits to society of reduced regulatory burden, especially if the benefits have mainly accrued to the affected banks?
- 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?
- Should capital requirements be rebalanced so that risk-weighted requirements are more likely to be binding than leverage requirements such as the SLR? If so, should this be accomplished by raising risk-weighted requirements, lowering leverage requirements, or providing exemptions for safe assets from leverage requirements? Would the SLR cease functioning as an effective backstop if safe assets were exempted from it?

For more information, see CRS Report R45711, *Enhanced Prudential Regulation of Large Banks*, by Marc Labonte.

Basel III Endgame

Following the financial crisis, an international agreement among bank regulators known as Basel III led to major reforms in prudential bank standards to address problems that arose during the financial crisis. Filling in the details of the broad agreement has been a lengthy process. In September 2022, the federal banking regulators announced their intention to issue a proposed rule on "enhanced regulatory capital requirements that align with the final set of 'Basel III' standards issued by the Basel Committee on Banking Supervision in December 2017." The regulators noted that the proposal would apply only to large banks.[54] This last round of Basel III reforms is sometimes colloquially referred to as the Basel III Endgame or Basel IV. According to the BCBS:

> A key objective of the revisions … is to reduce excessive variability of risk-weighted assets (RWAs) … [and] help restore credibility in the calculation of RWAs by: (i) enhancing the

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[52] Federal Reserve and FDIC, "Resolution-Related Resource Requirements for Large Banking Organizations," press release, October 14, 2022, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20221014a.htm.

[53] Federal Reserve and FDIC, "Agencies Announce Forthcoming Resolution Plan Guidance for Large Banks and Deliver Feedback on Resolution Plan of Truist Financial Corporation," press release, September 30, 2022, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20220930a.htm.

[54] Board of Governors of the Federal Reserve System, FDIC, OCC, "Agencies Reaffirm Commitment to Basel III Standards," press release, September 9, 2022, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20220909a.htm.

> robustness and risk sensitivity of the standardised approaches for credit risk and operational risk, which will facilitate the comparability of banks' capital ratios; (ii) constraining the use of internally-modelled approaches; and (iii) complementing the risk-weighted capital ratio with a finalised leverage ratio and a revised and robust capital floor.[55]

The BCBS set (nonbinding) deadlines of January 2022 to January 2027 to implement these standards.

Community Reinvestment Act Modernization

The Community Reinvestment Act (CRA, 12 U.S.C. Ch. 30) was enacted in 1977 in response to concerns about fair lending and "redlining"—some banks' policies to avoid making credit available to minority neighborhoods.[56] The CRA requires bank regulators to "assess the institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with the safe and sound operation of such institution."[57] Regulators assign a rating to each bank based on its compliance with achieving the goals of the CRA. The primary regulatory incentive for banks to pursue a good rating is that the CRA requires regulators to take a bank's CRA rating "into account in its evaluation of an application," such as a merger application or an application for a BHC to become a financial holding company.

Congress has amended the CRA several times, most recently in 1999 (P.L. 106-102). According to the Fed, the last substantive regulatory update to the CRA was in 2005. CRA compliance is based on the concept of designated assessment areas. Since the last update, the way banks provide credit and services has changed, due in part to innovations such as online and mobile banking. In May 2022, the banking regulators proposed a joint rule to modernize the CRA.[58] The proposal would "update CRA assessment areas to include activities associated with online and mobile banking, branchless banking, and hybrid models" and adopt a metrics-based approach to CRA evaluation.[59] The proposal is tailored in complexity based on the size of an institution, creating new CRA evaluation tests for large banks and allowing small banks to opt in to the new framework or continue to be evaluated under the existing framework.

In July 2022, the House Financial Services Committee held a legislative hearing on the CRA that considered three bills.[60] Subcommittee Chair Ed Perlmutter stated, "The CRA rulemaking is an opportunity to ensure our financial system works for all Americans and to finally put an end to modern-day redlining. A strong CRA rule could be the catalyst we need to close the racial wealth gap." In his opening statement, Ranking Member Blaine Luetkemeyer praised the proposal for adding quantitative metrics to the CRA and expanding the focus beyond mortgage lending but

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

[56] OCC, Federal Reserve System, and FDIC, "Community Reinvestment Act," proposed rule, 87 *Federal Register* 33884, June 3, 2022, p. 33888, https://www.federalreserve.gov/consumerscommunities/files/cra-npr-fr-notice-20220505.pdf.

[57] 12 U.S.C. §2903.

[58] Federal Reserve, FDIC, OCC, "Agencies Issue Joint Proposal to Strengthen and Modernize Community Reinvestment Act Regulations," press release, May 5, 2022, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20220505a.htm.

[59] Federal Reserve, FDIC, OCC, *Community Reinvestment Act Proposal Fact Sheet*, May 2022, https://www.federalreserve.gov/consumerscommunities/files/cra-fact-sheet-20220505.pdf.

[60] U.S. Congress, House Committee on Financial Services, Subcommittee on Consumer Protection and Financial Institutions, *Better Together: Examining the Unified Proposed Rule to Modernize the Community Reinvestment Act*, 117th Cong., 2nd sess., July 13, 2022.

criticized the proposal for expanding assessment areas beyond branch locations and for imposing what he described as onerous data collection and compliance requirements. He also stated that the proposal should address what he characterized as the current practice of using the CRA to "hold banks hostage and extort money from them whenever a merger takes place."

Policy issues for Congress going forward include the following:

- Does the CRA need to be modernized to remain effective given business and technological changes in banking? Would the proposed rule strengthen or weaken the CRA?
- Does the fact that almost all banks pass the CRA tests mean that the criteria are too lax or that the CRA has been successful in accomplishing its goals?
- Can the CRA be effectively modernized through regulation alone, or is legislation needed?[61]

For more information, see CRS Testimony TE10077, *Better, Together: Examining the Unified Proposed Rule to Modernize the Community Reinvestment Act*, by Darryl E. Getter.

Mergers[62]

Mergers and acquisitions (M&As) involving banks—or, more technically, insured depository institutions, as there are a number of different types of banks—must comply with a number of statutory requirements.[63] These vary based on the type of bank but are broadly similar. Bank M&As need approval by the Fed when they involve banks or BHCs regulated by the Fed. (When banks with different charter types are merging, approval by more than one regulator can be required.) Most of the largest U.S. banks are structured as BHCs, and the Fed approves their M&As.[64]

Regulators review M&A proposals for, among other things, their effects on competition. For example, bank regulators and the Department of Justice (DOJ) review proposals for effects on market power in both national and local markets. DOJ has the authority to block an M&A on antitrust grounds. It is not uncommon for a bank to divest branches before an M&A is approved to allay concerns about market power. For example, on 16 occasions between 2006 and 2017, the Fed required M&A applicants to sell off branches.[65] M&As are also subject to statutory concentration limits to curb market power—the merged entity may not hold more than 10% of total deposits nationally or 30% of deposits in any state. In addition, for BHCs, the merged entity cannot hold over 10% of all financial company liabilities nationally.

Regulators must also consider the "convenience and needs of the community" by seeking public comment through public outreach hearings, for example. Notably, the entities merging must resolve any issues related to consumer compliance or compliance with the CRA (12 U.S.C. §2901

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[61] For example, in the 117th Congress, House Financial Services Chair Maxine Waters introduced H.R. 8833 to amend the CRA.

[62] This section draws from other CRS products co-authored with Andrew Scott.

[63] 12 U.S.C §1841 et seq and 12 U.S.C. §1828.

[64] BHCs may also acquire nonbank financial firms. The regulatory process described in this section, however, is focused on M&As involving two banks. States may also have requirements, beyond the scope of this report, but federal law allows a state regulator to block M&As only on limited grounds.

[65] Federal Reserve, letter to the Hon. Elizabeth Warren, May 10, 2018, p. 3, https://www.warren.senate.gov/imo/media/doc/Powell%20Response%20re%20Mergers.pdf.

et seq.). The M&A approval process is one of regulators' main tools to encourage CRA compliance.[66]

Statutes lay out other factors regulators must consider, including the following:

- **Financial resources**—would the merged institution have adequate capital and other resources?
- **Managerial resources**—do the banks' officers, directors, and principal shareholders have competence, experience, and integrity?
- **Anti-money laundering—**are the banks effective at combatting money laundering?
- **Financial stability**—does the merger pose systemic risk to the U.S. banking or financial system?

There are also restrictions on how certain acquisitions can be financed.

Regulators have discretion to reject M&A applications, require changes to proposals, and grant conditional approval. They can also waive certain requirements in certain circumstances, such as for a bank in default or in danger of default. For example, during the 2008 financial crisis, Wells Fargo's acquisition of Wachovia was approved on an expedited basis under a systemic risk exception.

On July 9, 2021, President Biden issued an executive order on competition, which, among other things, encourages the Attorney General and the federal banking regulators "to review current practices and adopt a plan, not later than 180 days after the date of this order, for the revitalization of merger oversight."[67] In September 2022, Vice Chair Barr announced that the Fed was reviewing its approach to approving bank mergers, which may lead to future rulemaking.[68] Congress has been interested in mergers among large banks in recent years, particularly how they might affect competition.

Some policymakers are concerned about the effect that bank mergers are having on competition, which can be viewed as two distinct concerns: (1) that mergers will lead to a dearth of community banks and (2) that mergers will lead to a handful of banks that are "too big to fail" (i.e., whose failure would cause financial instability) and have too much market share for markets to be competitive.

There is a long-term trend of consolidation in the banking industry, which has mainly occurred through M&A. This trend was driven by the gradual removal of state and federal restrictions on operating multiple branches and banks, notably across state lines. In other words, legal restrictions had kept banks artificially small. Once these restrictions were removed in the 1980s and 1990s, economies of scale made it profitable for banks to expand, and many small banks combined, with annual mergers peaking in 1997. Consolidation has continued throughout the 21st century. From 2001 to 2020, the number of FDIC-insured institutions (which includes commercial banks and savings associations) fell from 9,613 to 5,002. One potential explanation

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[66] For more information on the CRA, see CRS Report R43661, *The Effectiveness of the Community Reinvestment Act*, by Darryl E. Getter.

[67] The White House, "Executive Order on Promoting Competition in the American Economy," July 9, 2021, https://www.whitehouse.gov/briefing-room/presidential-actions/2021/07/09/executive-order-on-promoting-competition-in-the-american-economy/.

[68] Vice Chair for Supervision Michael S. Barr, "Making the Financial System Safer and Fairer," speech, September 7, 2022, https://www.federalreserve.gov/newsevents/speech/barr20220907a.htm.

for continued consolidation is that growing bank use of information technology creates greater economies of scale.

Most mergers involve small banks, but there have been a number of high-profile mergers in recent years involving "regional banks"—those that are second-largest in size after the G-SIBs and are typically based in a particular region—that have increased their size and reduced their number. For example, every one of the 10 largest banks (as measured by bank subsidiary assets) that is not a G-SIB as of September 2022 has been involved in a sizeable merger or acquisition in recent years.

Some have criticized the merger process as too lax. They point to the fact that none of the three regulators has denied a merger application in recent years and characterize the approval process as a mere "rubber stamp." Regulators disagree and describe the application process as an iterative one, where applicants are given the opportunity to provide more information or address shortcomings in their applications before judgment is passed. Sometimes applicants withdraw or never formally submit merger applications because they view them as unlikely to be approved.[69] Because the merger application process is iterative, it can be lengthy, and other critics complain that it is too slow and vulnerable to interference. The regulators have internal guidelines on how long the approval process should take.

Policy issues for Congress going forward include the following:

- Have recent mergers involving large banks reduced competition in the banking industry? Are mergers undermining community banks, or do mergers between community banks benefit consumers because of economies of scale and greater geographic reach? Do mergers between regional banks benefit consumers for the same reasons, and do they harm competition or promote it because it allows them to better compete with G-SIBs?
- Is the absence of any formal rejections a sign that the merger process is too lax relative to the statutory requirements in recent years, or is it a sign that the iterative process is working as regulators intend?
- Does the merger approval process take longer than is warranted? Do banks that cannot get mergers approved face a fair appeals process?
- Because independent bank regulators did not complete a review of the merger process within the time frame of the executive order, should Congress step in if changes to the current merger process are desired?

For more information, see CRS In Focus IF11956, *Bank Mergers and Acquisitions*, by Marc Labonte and Andrew P. Scott.

Cryptocurrency and Banking

Some banks have expressed interest in cryptocurrencies and other digital assets. Participation could take the form of traditional banks providing some types of cryptocurrency services or

[69] For example, State Street recently announced that it was no longer pursuing an acquisition of Brown Brothers Harriman's Investor Services business. It stated, "After consideration of both regulatory feedback and potential transaction modifications to address that feedback, State Street has determined that the regulatory path forward would involve further delays, and all necessary approvals have not been resolved." State Street, a BHC, did not specify which regulator's feedback it was basing its decision on. State Street, "Statement from State Street Corporation on Brown Brothers Harriman Investor Services Acquisition," press release, November 30, 2022, https://newsroom.statestreet.com/press-releases/press-release-details/2022/Statement-from-State-Street-Corporation-on-Brown-Brothers-Harriman-Investor-Services-Acquisition/default.aspx.

cryptocurrency firms seeking bank charters. Yet extreme and repeated increases and decreases 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.

In November 2021, the Fed, OCC, and FDIC announced a "Crypto-Asset Policy Sprint Initiative" in which the regulators "focused on quickly advancing and building on the agencies' combined knowledge and understanding related to banking organizations' potential involvement in crypto-asset-related activities."[70] The regulators identified areas where 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. Note that these activities are not necessarily limited to crypto firms—a traditional bank could potentially engage in any of them. The announcement stated that "the agencies plan to provide greater clarity on whether certain activities related to crypto-assets conducted by banking organizations are legally permissible." It did not state whether that clarity would take the form of rulemaking or guidance or be communicated less formally or on a case-by-case basis.

In August 2022, the Fed released a supervisory letter informing banks under its jurisdiction that they "must analyze the permissibility of such activities" and "should notify [their] lead supervisory point of contact at the Federal Reserve prior to engaging in any crypto-asset-related activity."[71]

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.[72] Typically, U.S. bank regulators have implemented Basel standards through the domestic rulemaking process.

Banks are closely regulated for safety and soundness and consumer protection, and a regulator could block any bank activity that is not consistent with any of these requirements. A central tenet of bank regulation is that banks should engage only in activities that are part of or incidental to the business of banking. Some of these activities are explicitly laid out in statute, while other activities have been interpreted to be related by the bank regulators. Bank regulators could choose to allow (or prohibit) some or all activities related to cryptocurrency if they find that they are (or are not) closely related to the business of banking. Alternatively, Congress could allow or prohibit these activities through legislation. If such activities were allowed, regulators have broad authority to impose requirements to mitigate risks to safety and soundness, consumer protection, and other regulatory requirements. A recent FSOC report recommended, among other things, that bank regulators continue to review whether their existing authority is sufficient.[73] Sometimes regulators or Congress decide that the risk-benefit tradeoff is not favorable and impose blanket

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[70] Board of Governors of the Federal Reserve System, FDIC, OCC, "Joint Statement on Crypto-Asset Policy Sprint Initiative and Next Steps," November 23, 2021, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20211123a1.pdf.

[71] 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.

[72] BCBS, Second Consultation on the Prudential Treatment of Cryptoasset Exposures, June 2022, https://www.bis.org/bcbs/publ/d533.pdf.

[73] 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.

bans on certain activities or asset classes.[74] For example, banks can be a source of systemic risk. High-risk activities might pose minimal systemic risk outside the banking system (even if they pose other risks) but could pose systemic risk if bank involvement threatened the solvency of the banking system.

Alternatively, a BHC might choose to place crypto-related activities in a nonbank subsidiary that is legally separate from the BHC's bank subsidiaries. Generally speaking, BHCs may own nonbank subsidiaries so long as the business of those subsidiaries is financial in nature.[75] As the regulator of BHCs, the Fed would have limited authority over the nonbank subsidiary, which is even more limited if the subsidiary had another primary regulator, such as the Securities and Exchange Commission. Under source-of-strength requirements, the Fed would have authority to require that the subsidiary not place the safety and soundness of the bank subsidiaries or holding company at risk.

Some crypto firms have received trust charters or other special purpose charters from state bank regulators or the OCC.[76] Such charters could potentially be granted with limits on activities that the firm could engage in, such as deposit taking. If a state-chartered institution became a member of the Federal Reserve System, the Fed would become its primary federal regulator. Generally, banks that do not accept insured deposits are not subject to all of the same regulations as banks that accept deposits are. If a state-chartered bank did not have a primary federal regulator, the Fed would need to decide whether to grant it a master account, as discussed in the section below entitled "Access to Master Accounts."

Although bank regulators have strong and broad authority to manage risk taking by banks, bank entry into crypto activities would not give bank regulators authority to address risks in the underlying crypto markets. This inherently limits the extent that those risks can be effectively managed. Fed Vice Chair Brainard argued, "It is important for banks to engage with beneficial innovation and upgrade capabilities in digital finance, but until there is a strong regulatory framework for crypto finance, bank involvement might further entrench a riskier and less compliant ecosystem."[77]

Policy issues going forward include the following:

- Are crypto activities inherently too risky for banks or BHCs to participate in? Are some types of crypto activities less risky or easier to regulate than others? Do crypto activities pose more risk to consumers and financial stability if they are inside or outside of the banking system? Would bringing crypto into the bank regulatory umbrella reduce risks or legitimize an industry that is inherently harmful to consumers and the economy?
- 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

[74] For example, the Volcker Rule imposes a ban on bank proprietary trading and sponsorship or private funds.

[75] To do so, BHCs must elect to become financial holding companies and meet certain regulatory requirements. Activities that are financial in nature are laid out in Title 12, Section 225.86, of the *Code of Federal Regulations*.

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

[77] Vice Chair Lael Brainard, "Crypto-Assets and Decentralized Finance Through a Financial Stability Lens," speech, July 8, 2022, https://www.federalreserve.gov/newsevents/speech/brainard20220708a.htm.

Congress preempt regulatory action to ensure that banks may or may not participate in certain aspects of crypto markets?

- Should crypto firms be granted federal bank charters? Should those charters be limited to special purpose or trust charters, and should crypto firms with federal or state charters have direct access to federal deposit insurance, the Fed's discount window, and payment systems operated by the Fed?

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

For more information, see CRS In Focus IF11997, *Bank Custody, Trust Banks, and Cryptocurrency*, by Andrew P. Scott.

Cannabis Banking

Many states have legalized marijuana, whereas it remains a Schedule I controlled substance under federal law.[78] As a result, it is a federal crime to grow, sell, or possess the drug. This disparity has implications for banks offering financial services to cannabis businesses that are legal under state law. Anti-money laundering (AML) laws prohibit financial institutions from handling the proceeds derived from marijuana business activities and certain other activities that are illegal under federal law. The Fed and other federal bank regulators enforce AML requirements for banks. Potential punishments for AML violations and other violations of federal law leave some banks leery of offering financial services to cannabis businesses operating in compliance with state law. If cannabis businesses are unable to access traditional financial services, they may face higher borrowing costs and may be heavily reliant on cash transactions, making them a target for theft.

To facilitate banks providing services to cannabis businesses, the House passed the SAFE Banking Act (H.R. 1996) in the 117th Congress. Among other things, the bill would have prevented regulators from penalizing banks solely for offering banking services to cannabis businesses operating in compliance with state law. It would have also provided legal protection to the Fed and its employees in providing services, such as payment services, to banks serving cannabis businesses operating in compliance with state law and allow the Fed to accept loans to cannabis firms as collateral at the discount window. The bill would have required that the bank regulators clarify that offering banking services to businesses producing goods using hemp is legal under federal law. The bill would have prohibited bank regulators from requesting that banks terminate customer accounts without a valid reason and solely on the basis of reputational risk. The bill would have reduced the Fed's surplus as a "pay for" under scoring rules.

Policy issues going forward include the following:

- Should banking services be made available for businesses engaged in an activity that is legal under state law and illegal under federal law?
- Have cannabis businesses been harmed by federal barriers to accessing banking? Have these barriers operated in practice as an effective deterrent to the legal use of marijuana under state law?
- Is a legal safe harbor to banks providing services to cannabis businesses justified absent a broader reform of federal cannabis laws? In other words, should banks

[78] For more information, see CRS Report R44782, *The Evolution of Marijuana as a Controlled Substance and the Federal-State Policy Gap*, coordinated by Lisa N. Sacco.

be singled out for legal protection when other participants in cannabis markets continue to be exposed to prosecution under federal law?

For more information, see CRS Testimony TE10031, *Challenges and Solutions: Access to Banking Services for Cannabis-Related Businesses*, by David H. Carpenter and CRS Report R44782, *The Evolution of Marijuana as a Controlled Substance and the Federal-State Policy Gap*, coordinated by Lisa N. Sacco.

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 wholesale payment systems for those institutions:

- the Automated Clearinghouse (ACH) for wholesale credit and debit transfers,
- check clearing,
- Fedwire Funds Service for gross settlement of large value payments,
- Fedwire Securities Service for settlement of government and government agency securities, and
- National Settlement Service for multilateral payment settlement among the largest payment market participants.

The Fed offers intraday credit to participants in its payment services to help them avoid settlement failure. The Fed is planning to launch FedNow, a real-time settlement system that will allow banks to offer real-time retail payments, in mid-2023.[79] 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.[80] 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 not all payment system participants (that are not banks) are under its jurisdiction.[81] Title VIII of the Dodd-Frank Act subjects payment, clearing, and settlement systems designated as systemically important financial market utilities (FMUs) by the FSOC to enhanced supervision by the Fed.[82] Since 2012, the Fed has regulated two FMUs, the Clearing House Payments Company and CLS Bank International. The Fed also regulates (in some cases, in conjunction with other regulators) aspects of bank retail payments for consumer protection.

[79] Federal Reserve, "FedNow Service," https://www.federalreserve.gov/paymentsystems/fednow_about.htm. Currently, some banks provide real-time retail payments to customers through a private sector competitor to FedNow. For more information, see CRS Report R45927, *U.S. Payment System Policy Issues: Faster Payments and Innovation*, by Cheryl R. Cooper, Marc Labonte, and David W. Perkins.

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

[81] 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.

[82] 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.

Current payment systems issues of interest to Congress discussed below are the regulation of payment stablecoins, central bank digital currencies, and Fed master accounts.

Payment Stablecoins

Stablecoins are cryptocurrencies that are tied in value to some reference currency.[83] 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 payments currently.

Stablecoins face run risk—stablecoin holders who wish to convert into dollars rely on the issuer's ability to meet redemption demands. If holders believe that the 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, such as consumer protection or promoting innovation in payments or because run risk potentially poses systemic risk, as FSOC has argued.[84]

Members of Congress from both parties on both the House Financial Services Committee and the Senate Banking Committee have called for legislation to regulate payment stablecoins. In some proposals, nonbanks would be allowed to issue payment stablecoins but would be regulated by the Fed. Alternative regulatory models include the Securities and Exchange Commission's regulation of money market funds.

A 2021 report issued by the Treasury, Fed, and others called for prudential regulation of payment stablecoins to address systemic risk.[85] Specifically, the report called for legislation allowing only insured depositories, which are regulated for safety and soundness by the banking regulators, including the Fed, to issue payment stablecoin. In the absence of legislation, the report called for FSOC to consider designating payment stablecoins as systemically important FMUs under the jurisdiction of the "appropriate agency." Currently, the Fed regulates payment systems that have been designated as FMUs. Title VIII of the Dodd-Frank Act envisions payment systems to be designated as FMUs on a case-by-case basis, as opposed to a blanket application to a class of assets, however. Further, a retail payment system has never been designated as an FMU.[86]

Policy issues going forward 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 a workable legal distinction be made between payment stablecoins and other stablecoins?

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

[84] 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.

[85] 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.

[86] See CRS Report R41529, *Supervision of U.S. Payment, Clearing, and Settlement Systems: Designation of Financial Market Utilities (FMUs)*, by Marc Labonte.

- Should banks, nonbanks, or both be permitted to issue stablecoins, given financial stability concerns? If so, should bank issuance be limited to payment stablecoins?
- Should stablecoins be backed by the federal safety net, including access to federal deposit insurance, Fed master accounts, and the Fed's discount window?
- Is legislation required to implement bank stablecoin regulation by bank regulators?
- Would stablecoins meet the statutory definition of a significantly important FMU, irrespective of their size or importance? Does the Fed's authority to regulate FMUs address the risks posed by stablecoins?

For more information, see CRS Legal Sidebar LSB10754, *Stablecoins: Legal Issues and Regulatory Options (Part 2)*, by Jay B. Sykes.

CBDC[87]

The recent proliferation of private digital currencies or 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.

In addition, several countries are moving forward with plans to create CBDCs, and this has increased calls for the Fed to act. According to a survey from the Bank for International Settlements, "Nine out of 10 central banks are exploring central bank digital currencies (CBDCs), and more than half are now developing them or running concrete experiments."[88] For example, China has completed several digital currency trials in major cities across the country, as well as cross-border trials with Hong Kong; the European Central Bank hopes to launch a digital euro by 2025; the Eastern Caribbean is piloting its digital currency (DCash) in four countries; and the Bank of Japan has announced a "phase one" of testing a digital yen. 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 "reserve currency" status.[89]

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 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 after the Fed rolls out FedNow, its planned real-time settlement system. Creating a CBDC could take several years, whereas FedNow is expected to be operational in 2023. Whether payments using a CBDC would be less expensive than the status quo remains unknowable until detailed proposals have been made. (Cross-border payments have 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

[87] This section draws from other CRS products co-authored with Rebecca Nelson.

[88] Anneke Kosse and Ilaria Mattei, *Gaining Momentum—Results of the 2021 BIS Survey on Central Bank Digital Currencies*, May 2022, https://www.bis.org/publ/bppdf/bispap125.pdf.

[89] 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.

able to hold CBDCs in accounts at the Fed 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,[90] and the effectiveness of monetary policy. If the CBDC mainly crowded out cash and cryptocurrency use, it could make illicit activity more difficult, possibly at some expense of individual privacy. If a CBDC is used to deliver government payments, its ability to improve their speed and efficiency would depend on the extent of its adoption by those not already receiving payments by direct deposit, which might be low unless mandatory.

To date, the Fed and Treasury have not taken a position on whether creating a CBDC 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."[91] Likewise, a recent Treasury report in response to an executive order[92] did not take a position on whether the United States should pursue a CBDC.[93] The report called for the creation of an interagency working group to work through the various issues raised in the report. The Fed report argued against a FedAccounts model (where the Fed would offer retail services directly to consumers) and argued for allowing individuals to use CBDC directly (as opposed to limiting their use to financial institutions), whereas the Treasury report took no position on design features. Regardless, 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 prevent one from being introduced.

Policy issues 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? What advantages would CBDC provide once FedNow is operational?
- Could international coordination on CBDCs improve the efficiency of cross-border transactions?

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

[91] 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.

[92] The White House, "Ensuring Responsible Development of Digital Assets," Executive Order 14067, March 9, 2022, https://www.presidency.ucsb.edu/documents/executive-order-14067-ensuring-responsible-development-digital-assets. In response to the executive order, the White House Office of Science and Technology Policy also produced a report on technical issues surrounding creation of a CBDC. See White House Office of Science and Technology Policy, *Technical Evaluation For A U.S. Central Bank Digital Currency System*, September 2022, https://www.whitehouse.gov/wp-content/uploads/2022/09/09-2022-Technical-Evaluation-US-CBDC-System.pdf.

[93] U.S. Department of the Treasury, *The Future of Money and Payments*, September 2022, https://home.treasury.gov/system/files/136/Future-of-Money-and-Payments.pdf.

- Would CBDCs promote financial inclusion by offering an attractive alternative to the unbanked, or would they widen the "digital divide"?
- Would a CBDC enable faster and more efficient government payments?
- How would a CBDC balance privacy and preventing illicit activity?
- What effect would a CBDC have on financial stability?
- Would a CBDC increase or decrease cybersecurity risk?
- Would CBDCs make monetary policy more or less effective?
- Would CBDCs generate more government seigniorage than the current system can?
- How could the U.S. dollar be affected by other countries' adoption of CBDCs?
- Would new legislation or regulation be needed to operate a CBDC?

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

Access to Master Accounts

Financial technology (fintech) has led to innovation in retail payments by both traditional banks and fintech firms.[94] Although these fintech firms do not necessarily provide traditional banking services besides payment processing, some have sought—and some have been granted—state or federal bank charters. For payment firms, a major motivation for seeking a bank charter is to obtain a Fed "master account" to access wholesale payment systems and related Fed payment services without needing a bank to act as its intermediary.[95] More recently, cryptocurrency firms with state bank charters have applied for master accounts in order to more seamlessly transact between crypto and official currency.[96]

All types of payments between end users (such as customers and merchants) with different banks using different payment systems can be seamlessly completed because master accounts are connected to each other at the Fed. Customer payments are aggregated and netted by banks, which can then debit and credit each other's master accounts through wholesale payment systems, where they are cleared and settled. Without a master account, a payment provider is reliant on a bank with a master account to complete transactions with outside parties.

Institutions must apply to the Fed to receive master accounts. These applications have typically been approved quickly for traditional banks, but some nontraditional applicants have reportedly faced delays, causing consternation.[97] The growing number of nontraditional applicants has raised policy questions about who is and who should be eligible for master accounts (under existing law

[94] For more information, see CRS Report R46332, *Fintech: Overview of Innovative Financial Technology and Selected Policy Issues*, coordinated by David W. Perkins.

[95] Access to a master account does not automatically confer access to the Fed's discount window. Examples of Fed-provided payment services are listed in Title 12, Section 248a(b), of the *U.S. Code* and are described at https://www.federalreserve.gov/paymentsystems.htm.

[96] For more information, see CRS In Focus IF11997, *Bank Custody, Trust Banks, and Cryptocurrency*, by Andrew P. Scott.

[97] Julie Andersen Hill, "Opening a Federal Reserve Account," *Yale Journal on Regulation*, vol. 40 (forthcoming), October 6, 2022, http://dx.doi.org/10.2139/ssrn.4048081.

or through legislation), how transparent the application process should be, and what safeguards the Fed should impose on firms with master accounts.

Emblematic of this debate, two recent examples have attracted policymakers' interest. First, the master account application of Reserve Trust, a fintech payment company with a state trust bank charter, was raised at the confirmation hearing for Fed nominee Sarah Bloom Raskin, who had previously served on Reserve Trust's board of directors.[98] Second, Custodia Bank, a Wyoming state-chartered special purpose bank specializing in cryptocurrency services, has sued the Fed for delaying a decision on its October 2020 master account application.[99] Other examples of controversial applications reportedly include Territorial Bank of American Samoa (a public bank), TNB (a "narrow bank,") and Fourth Corner Credit Union (a bank to provide services to cannabis businesses).[100]

The Fed issued final guidance in August 2022 through the notice-and-comment process explaining how it would evaluate master account applications.[101] According to the Fed, the guidance would make the application process more transparent and ensure that applications from nontraditional institutions were treated consistently among the 12 regional Federal Reserve banks that decide on applications in their districts.

According to the final guidance, by law, the Fed may grant master accounts only to firms that meet the statutory definition of *member bank* or *depository institution*, designated FMUs, certain government-sponsored enterprises, the U.S. Treasury, and certain official international organizations. For eligible institutions, applicants must be in compliance with relevant laws and regulatory requirements related to payments, AML, sanctions, and risk management, among others; be financially healthy; and not pose risk to the Fed or financial stability.

Assuming an applicant is legally eligible, the final guidance separates applicants into three tiers, with each tier receiving progressively more scrutiny before approval. Applicants that are federally insured depository institutions will receive the least scrutiny, institutions that are not federally insured but are subject to prudential supervision by a federal banking agency or have holding companies that are supervised by the Fed will 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 will receive the most scrutiny. The Fed's rationale for this tiered application process is based on how closely regulated the institution is and how much information is available to the Fed about the institution. On November 4, 2022, the Fed proposed to begin publicly disclosing institutions with master accounts on a quarterly basis.[102] In the 117th Congress, Title LVIII, Subtitle F of the National Defense and Authorization Act for FY2023 (P.L. 117-263) requires the Fed to publicly release a quarterly list of institutions (excluding official institutions) that have requested, been rejected for, or been granted master accounts.

98 Senate Banking Committee, "Toomey Presses Raskin on Work for Obscure Fintech That Obtained Unusual Access to Fed's Payment Systems," press release, February 7, 2022, https://www.banking.senate.gov/newsroom/minority/toomey-presses-raskin-on-work-for-obscure-fintech-that-obtained-unusual-access-to-feds-payment-system.

99 Davis Polk, "Crypto Bank Sues Federal Reserve over Delay in Master Account Application," June 16, 2022, https://www.davispolk.com/insights/client-update/crypto-bank-sues-federal-reserve-over-delay-master-account-application.

100 Hill, "Opening a Federal Reserve Account."

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

102 Federal Reserve, "Guidelines for Evaluating Account and Services Requests," https://www.federalreserve.gov/newsevents/pressreleases/files/other20221104a1.pdf.

In the context of fintech and crypto applicants, there is a policy tradeoff between the desire to foster innovation and mitigate risks—which may be poorly understood—to the Fed and financial stability posed by innovation. Compared to non-crypto fintech payment firms, crypto firms pose additional risk given the extreme volatility in cryptocurrency prices, numerous examples of scams and fraud, regulatory uncertainty, and several high-profile and abrupt failures of crypto firms. Master accounts for innovative payment firms may deliver lower costs and new product options for consumers and merchants. Meanwhile, the lack of an explicit, comprehensive federal regulatory system for payments leaves the Fed reliant on rules within the payment systems it operates and federal regulation of banks to manage payment risks.[103] At the same time, the dual state-federal banking system can result in limited federal oversight when a state-chartered institution does not have federal deposit insurance.[104] As a result, the Fed could find itself with limited ability to monitor or mitigate risks after a master account has been granted to an institution with no primary federal regulator.

Policy issues for Congress moving forward include the following:

- Should master accounts be made available to any institution that is legally eligible, or should legislation limit them to traditional banks (e.g., banks with deposit insurance and a primary federal regulator)? Should a nontraditional firm benefit from valuable Fed services without bearing the regulatory costs applied to other users to access those services (and other benefits).[105]
- What risks would granting master accounts to firms offering crypto services pose to the payment system, the Fed, and financial stability?
- Should there be a time limit on Fed decisions on master account applications? It is unclear whether the Fed has processed nontraditional applications more quickly since the guidance was released.
- Will the new statutory requirement to publicly release information on master account holders and applicants sufficiently address concerns about transparency?
- Is legislation needed to provide greater clarity on who should be granted master accounts and force the Fed to act more quickly on applications?[106] Or should Congress defer to the Fed's independence on what some consider a niche and esoteric issue?

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

[103] There are a limited number of federal laws pertaining to payments, most dealing with consumer protection issues or preventing illicit activity. The Fed manages payment system risk, in part, through its own policy. See Federal Reserve, *Policy on Payment System Risk*, March 19, 2021, https://www.federalreserve.gov/paymentsystems/files/psr_policy.pdf.

[104] State-chartered depository institutions with federal insurance are subject to federal regulation comparable to nationally chartered institutions. For more information on charters, see CRS Report R47014, *An Analysis of Bank Charters and Selected Policy Issues*, by Andrew P. Scott.

[105] American Bankers Association et al, *Guidelines for Evaluating Account and Services Requests*, comment letter, April 22, 2022, https://www.aba.com/-/media/documents/comment-letter/jointltrevaluatingaccount20220422.pdf.

[106] In the 117th Congress, S. 4356 would have required the Fed to provide master accounts to all depository institutions. See Norbert Michel, "Congress Should Act to Grant Access," *Forbes*, August 22, 2022, https://www.forbes.com/sites/norbertmichel/2022/08/22/congress-should-give-fintechs-access-to-feds-settlement-services/.

Lender of Last Resort

The Fed was originally created primarily to act as a lender of last resort, but over time, this role became subordinated to its other responsibilities (in normal financial conditions), which grew out of its lender of last resort role. In normal market conditions, the Fed's lender of last resort operations are minimal, but they have been important during periods of financial instability, such as the 2007-2009 financial crisis.

Despite their name, Federal Reserve banks do not carry out any retail banking activities, with one limited exception: The Fed traditionally acts as lender of last resort by making short-term loans to commercial banks through its discount window.[107] Banks offer their assets as loan collateral to protect the Fed from losses. The Fed generally sets the *discount rate* charged for these loans above market rates.

Less frequently throughout its history, the Fed has also provided liquidity to firms that were not banks under emergency authority found in Section 13(3) of the Federal Reserve Act (12 U.S.C. §343).[108] This authority has been used extensively in only three crises—the Great Depression, the 2007-2009 financial crisis, and the COVID-19 pandemic. In the latter two cases, the Fed used that authority to create a series of emergency facilities to support nonbank financial markets and firms. The Fed can finance discount window lending and credit through its emergency facilities by expanding its balance sheet.

Until the Dodd-Frank Act, this authority was broad, with few limitations. One pre-financial crisis limitation was that the authority could be used only in "unusual and exigent circumstances." Concerns in Congress about some of the Fed's actions under Section 13(3) during the financial crisis led to statutory changes in Section 1101 of the Dodd-Frank Act. Generally, the intention of the provision in the Dodd-Frank Act was to prevent the Fed from rescuing failing firms while preserving enough of its discretion that it could still create broadly based facilities to address unpredictable market access problems during a crisis.[109]

COVID-19 Response

The COVID-19 pandemic caused widespread disruptions to the economy and, initially, the financial system. In response to the pandemic, the Fed acted as lender of last resort by encouraging use of the discount window and creating an alphabet soup of emergency programs under Section 13(3) to stabilize the financial system and assist entities cut off from credit markets. 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). (As discussed above, the Fed also supported the economy during the pandemic through monetary policy, reducing interest rates and expanding its balance sheet.[110])

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107 The Fed's lending facility is called the discount window because in the Fed's early years, banks that wanted loans would take their securities to a window at their Federal Reserve banks to be discounted.

108 See CRS Report R44185, *Federal Reserve: Emergency Lending*, by Marc Labonte.

109 See, for example, the *Joint Explanatory Statement of the Committee of the Conference to* P.L. 111-203, H.Rept. 111-517, 111th Cong., June 29, 2010.

110 The Fed and other bank regulators also provided regulatory relief to banks during the COVID-19 pandemic to support lending. For more information, see CRS Report R46422, *COVID-19 and the Banking Industry: Risks and Policy Responses*, coordinated by David W. Perkins.

The Fed encouraged banks to use the discount window and made the borrowing terms more attractive when the pandemic began. Discount window use peaked at about $50 billion and then fell relatively quickly in the spring of 2020, falling below $1 billion outstanding in 2021. Because foreign banks are reliant on U.S. dollar funding but cannot borrow from the discount window, the Fed has also allowed foreign central banks to swap their currencies for U.S. dollars so that the central banks can lend those dollars to banks in their jurisdictions. Swaps outstanding peaked at nearly $450 billion in May 2020 but have been below $1 billion since 2021.

The Fed created facilities to assist commercial paper (a type of short-term unsecured debt) markets, corporate bond markets, money market mutual funds, primary dealers, asset-backed securities, states and municipalities, and a Main Street Lending Program (MSLP) for mid-size businesses and nonprofits. It also created a facility to make funds available for lenders to make loans to small businesses through the Paycheck Protection Program (another CARES Act program).

The Fed charged interest and fees to use these facilities, but the facilities exposed taxpayers to the risk of losses if borrowers default or securities fall in value. Assistance outstanding under these facilities peaked at nearly $200 billion in April 2020 but hovered around $100 billion for the rest of the year, and some assistance currently remains outstanding. Treasury pledged $215 billion (of which $195 billion were CARES Act funds) to backstop potential losses on these facilities. In retrospect, all of the facilities either made a "profit" (i.e., had positive net income over their lifetimes) or are currently projected to make a profit for the Fed and Treasury, except possibly the MSLP.[111]

As financial conditions improved rapidly—faster than the economy improved—take up for the programs turned out to be much smaller than their announced size. The emergency programs backed by the CARES Act expired at the end of 2020, while most other emergency programs were extended until March 2021. P.L. 116-260 prohibited the Fed from reopening CARES Act programs for corporate bonds, municipal debt, and the MSLP.

Policy issues for Congress moving forward include the following:

- Should Congress make further changes to Section 13(3), or did those powers work as Congress intended during the pandemic?
- 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, what changes to the Fed's lending or regulatory powers are appropriate to mitigate that risk?
- Did the Fed's facilities disproportionately benefit investors in sophisticated financial products, who are disproportionately at the top of the income distribution, or did the benefits of Fed facilities mainly get passed through to the

[111] This analysis does not consider whether the programs made an economic profit (i.e., whether the government earned a market rate of return). The financial performance of the facilities is reported at https://www.federalreserve.gov/publications/reports-to-congress-in-response-to-covid-19.htm. The Fed states in these reports that it does not expect any of the facilities to impose losses on the Fed but does not specify whether the facilities are expected to impose losses on Treasury for those facilities that are backed by funding from the Treasury. CRS analyzed these reports to conclude that only the MSLP could potentially result in a net loss when wound down based on each facility's income and losses to date, the current market value of outstanding assets, and current outstanding liabilities. The MSLP could result in losses, which would be absorbed by the Treasury's investment under the CARES Act, because its actual losses to date and loan loss allowances currently exceed income. However, actual losses when the program is wound down in the future could prove to be larger or smaller than what the Fed has currently set aside in loan loss reserves.

broader economy via a faster and more robust recovery that broadly benefited all households?

- Has operating emergency facilities undermined the Fed's independence or political neutrality?
- In future crises, should facilities that provide longer-term credit—as opposed to short-term liquidity—to specific financial sectors be created and administered by the Fed or Treasury? Should the Exchange Stabilization Fund be used again to back Fed facilities in the future, and should its statutory authority be revised to positively or negatively reflect that?

For more information, see CRS Report R46411, *The Federal Reserve's Response to COVID-19: Policy Issues*, 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. (The Federal Reserve banks are more independent than the Board of Governors in the sense that they are subject to fewer of the rules that apply to government agencies.) The tradeoff to a more independent Fed is limits to congressional and executive input into and oversight of its actions. 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 financial crisis. Some critics downplay the degree of Fed oversight and disclosure that already takes place.

For oversight, the Fed is required to provide Congress with a written report on monetary policy semiannually, and both the chair and vice chair for supervision are required to testify before the committees of jurisdiction semiannually. In addition, these committees periodically hold more focused hearings on Fed topics. Governors are subject to presidential nomination and Senate confirmation, as are the leadership positions on the Board. The Fed's regional bank presidents, who vote with the governors on monetary policy decisions, and regional bank directors are not subject to Senate confirmation but are chosen, in part, by the Board of Governors.

One notable difference between the Fed and most other government agencies is that there is no congressional budgetary oversight of the Fed—the Fed is self-financing and its budget is not subject to the appropriations or authorization process. Thus, there is no regular avenue for Congress to ensure that the Fed is devoting resources to congressional priorities or to use congressional control over resources as leverage to achieve its goals.

Critics have sought a Government Accountability Office (GAO) audit of the Fed. The Fed's financial statements are already required to be annually audited by private sector auditors.[112] Contrary to popular belief, GAO has periodically conducted Fed audits since 1978, subject to statutory restrictions, and a GAO audit would not, under current law, release any confidential information identifying institutions that have borrowed from the Fed or the details of other transactions. The Dodd-Frank Act (P.L. 111-203) resulted in an audit of the Fed's emergency activities during the financial crisis and an audit of Fed governance. GAO can currently audit Fed activities for waste, fraud, and abuse. Effectively, the remaining statutory restrictions prevent GAO from evaluating the economic merits of Fed monetary policy decisions.

[112] Section 11B of the Federal Reserve Act (12 U.S.C. §248b). Since 2012, the Fed has voluntarily released unaudited financial statements quarterly as well. Those statements can be found at http://www.federalreserve.gov/monetarypolicy/bst_fedfinancials.htm#quarterly.

In its rulemaking, the Fed follows the standard notice-and-comment process, which provides some transparency to the Fed's decisionmaking process and gives the public a chance to weigh in on regulatory proposals. However, as an independent agency, the Fed's rulemaking is not subject to executive review by the Office of Information and Regulatory Affairs and cost-benefit analysis requirements under Executive Order 12866.[113] The Fed has an ombudsman and an appeals process for its supervisory decisions, such as exam results. The Fed also has an inspector general that regularly issues public reports stemming from its investigations.

For disclosure, the Fed is statutorily required to release an annual report of its operations and actions and a weekly summary of its balance sheet.[114] The Fed is required to report to Congress within seven days about any use of its emergency lending powers, with monthly updates as long as lending is outstanding. In December 2010, the Dodd-Frank Act required the Fed to release individual lending records for emergency facilities created during the financial crisis, revealing borrowers' identities and loans' terms for the first time. Going forward, individual records for discount window and open market operation transactions have been released with a two-year lag. The CARES Act also included testimony and reporting requirements for Fed actions involving CARES Act funding.[115] Congress occasionally requires the Fed to produce reports on other miscellaneous topics.[116]

Until 1993, the Fed did not publicly announce its monetary policy decisions (e.g., interest rate changes). The Fed has released minutes from its monetary policy deliberations (FOMC meetings) with a three-week lag since 1993 and transcripts of those deliberations with a five-year lag since 1995.[117] In 2009, the Fed began releasing the economic and monetary policy projections of Fed officials. In 2011, the chairman began holding quarterly press conferences following FOMC announcements. The Fed also releases information on its rulemaking, policies, and enforcement actions on its website. The board is subject to the Freedom of Information Act (FOIA), although it sometimes invokes exemptions provided in that act to deny FOIA requests.[118] (Critics have called for making the Federal Reserve banks subject to FOIA as well.) Some studies found the Fed to rank as one of the more transparent central banks in the world.[119]

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

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[113] For more information, see CRS Report R41974, *Cost-Benefit and Other Analysis Requirements in the Rulemaking Process*, coordinated by Maeve P. Carey.

[114] §§10(7), 10(10), and 11(a)(1) of the Federal Reserve Act (12 U.S.C. §247, 12 U.S.C. §247a, and 12 U.S.C. §248(a), respectively).

[115] For more information, see CRS Report R46329, *Treasury and Federal Reserve Financial Assistance in Title IV of the CARES Act (P.L. 116-136)*, coordinated by Andrew P. Scott.

[116] Other Fed reports to Congress can be accessed at http://www.federalreserve.gov/publications/other-reports/default.htm.

[117] From 1970 to 1993, the Fed released other information on FOMC meetings. See David Lindsey, *A Modern History of FOMC Communication*, June 2003, http://fraser.stlouisfed.org/docs/publications/books/20030624_lindsey_modhistfomc.pdf.

[118] The nine FOIA exemptions and their relevance to the Fed are detailed at http://www.federalreserve.gov/generalinfo/foia/exemptions.cfm. For background on FOIA, see CRS Report R41933, *The Freedom of Information Act (FOIA): Background, Legislation, and Policy Issues*, by Wendy Ginsberg.

[119] 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*, December 2008, vol. 24, no. 4, 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 1998 because the Fed discontinued its release of money growth targets between those dates.

Fed releases to the public. A potential consequence of greater oversight is that it could undermine the Fed's political independence. Most economists contend that the Fed's political independence leads to better policy outcomes and makes policy more effective by enhancing the Fed's credibility in the eyes of market participants. In the past, the Fed has opposed proposals to remove statutory restrictions on GAO audits and require a GAO audit on the grounds that they would reduce the Fed's independence from Congress. 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 challenge for Congress is to strike the right balance between a desire for the Fed to be responsive to Congress and for the Fed's decisions to be immune from short-term political calculations.

Title LVIII, Subtitle F of the National Defense and Authorization Act for FY2023 (P.L. 117-263) requires the Fed to adopt data standards to publish its publicly available data in an open data format. It does not require the Fed to make any new data public.

Policy issues for Congress going forward include the following:

- What is the right balance between Fed independence and oversight and accountability?
- Have existing statutory restrictions interfered with GAO's ability to evaluate the Fed on issues of congressional interest?
- Has disclosure of lending records since the 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?
- Should more federal statutes applying to the board and other government agencies (such as FOIA) 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?
- 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 regulatory process 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?
- Does the 2021 trading scandal involving Federal Reserve bank presidents indicate that more congressional oversight is needed?[120] Does the Fed's 2022 rules banning trading by leadership obviate the need for legislation?[121]

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

[120] 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.

[121] In the 117th Congress, Senate Banking 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.

Diversity

Some Members of Congress believe that the Fed and the banking sector suffer from a lack of diversity 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 (OMWI) for the Federal Reserve System and other federal financial regulators.

In the 117th Congress, the House passed the Federal Reserve Racial and Economic Equity Act (H.R. 2543), a wide ranging bill that included several provisions involving the Fed:

- Title I would have assigned the Fed a duty to eliminate racial and economic disparities in carrying out its monetary policy and other responsibilities and would have required the Fed to report to Congress semiannually on racial and ethnic disparities.
- Title II would have required banks with over 100 employees regulated by the Fed (and other federal financial regulators) to submit data to the OMWI.
- Title III would have required the Fed and Treasury Secretary to issue guidance on the regulatory capital treatment of Emergency Capital Investment Program investments for Subchapter S and mutual banks. Title III would have also required the Fed to make the discount window available to minority depository institutions (MDIs) and community development financial institutions (CDFIs) at the seasonal credit rate.
- Title IV would have required the Fed, OCC, FDIC, National Credit Union Administration, and CFPB to conduct a study and submit a strategic plan to Congress to promote the chartering of de novo (i.e., new) banks, including MDIs and CDFIs. Title IV would have also required the Fed (and other federal banking regulators) to include a diversity and inclusion component to their supervisory ratings of banks, create an "impact bank" designation for banks with less than $10 billion in total assets and loans to low-income borrowers equal to or greater than 50% of assets, create a Minority Depositories Advisory Committee to advise the agency, and produce a report on the diversity of its bank examiners.
- Title VI would have required Fed regional banks to interview at least one individual reflective of gender diversity and at least one individual reflective of racial or ethnic diversity when hiring a regional bank president.

Policy issues for Congress moving forward include:

- Should monetary policy be used to promote the goal of racial equity, or are interest rates a tool that is not capable of effectively addressing racial equity?
- Is Fed leadership sufficiently diverse? Should Congress require greater diversity or explicitly prohibit discrimination in the selection of all leadership positions at the Fed?
- Can the bank supervisory process be used to improve diversity at banks, or would such a policy detract from the current goals of supervision?

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