Introduction to Financial Services: The Federal Reserve

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

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

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

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

The Fed conducted large-scale asset purchases of Treasury- and mortgage-backed securities from 2008 to 2014—known as quantitative easing—that increased the size of its balance sheet. Since then, the Fed has begun to normalize monetary policy. In December 2015, the Fed raised the federal funds rate above zero, where it had been since December 2008. In September 2017, the Fed began gradually winding down its balance sheet. Quantitative easing has boosted the Fed’s remittances to the Treasury in recent years, but normalization is likely to reduce remittances.

Lender of Last Resort. Despite their name, Federal Reserve banks do not carry out any banking activities, with one limited exception. The Fed traditionally acts as lender of last resort by making short-term, collateralized loans to banks through its discount window. The Fed generally sets the discount rate charged for these loans above market

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

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

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

Figure 1. Federal Reserve Districts

Source: Federal Reserve.

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rates. In normal market conditions, the Fed’s lending operations are minimal. In the 2007-2009 financial crisis, it created a number of temporary emergency facilities to provide assistance to the broader financial system.

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

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

**Policy Issues**

**Congressional Oversight.** Congress has delegated monetary policy to the Fed but conducts oversight to ensure the Fed meets its statutory mandate of “maximum employment, stable prices, and moderate long-term interest rates.” The Fed has defined stable prices as a longer-run goal of 2% inflation.

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

The Fed is statutorily required to testify semiannually before and present a written report to the House Financial Services Committee and the Senate Banking, Housing, and Urban Affairs Committee. Congress has debated whether the Fed should report to it more frequently and in more detail. Congress has also debated what types of information the Fed should publicly disclose. Disclosure helps Congress and the public to better understand the Fed’s actions. Up to a point, this makes monetary and regulatory policy more effective, but too much disclosure could make both less effective because they rely on market-sensitive and confidential information. The Dodd-Frank Act (P.L. 111-203) required the Fed to release information with a lag on the identities of all borrowers and the terms of borrowing.

**GAO Audits.** To enhance oversight, Congress has considered removing statutory restrictions on Government Accountability Office (GAO) audits of the Fed. Contrary to popular belief, GAO already audits the Fed upon congressional request, but it is prohibited by law from conducting economic analyses of monetary or lender-of-last-resort activities. The Dodd-Frank Act broadened GAO’s audit authority and required two one-time audits of the Fed. Although removing GAO audit restrictions may increase accountability, Fed leaders oppose such a change, arguing that it would undermine the Fed’s independence from Congress and politicize monetary policy.

**Balance Sheet.** Congress has conducted oversight of the gradual wind down of the Fed’s large balance sheet. The Fed is expected to reach a decision on the ultimate size of the balance sheet and bank reserves and to what extent it will rely on interest on bank reserves for conducting monetary policy when policy normalization is completed. Congress has also reduced the Fed’s financial surplus as a budgetary “pay for” in recent unrelated acts (P.L. 114-94, P.L. 115-123, P.L. 115-174).

**Regulation.** Congress granted large and small banks regulatory relief from Fed regulation in P.L. 115-174. Finding the optimal tradeoff between the benefits and costs of financial regulation continues to be debated. Congress has also been concerned about whether the Fed is susceptible to regulatory capture, the concept that regulated entities have undue influence over regulation.

**Emergency Lending.** The Fed’s use of its emergency authority (Section 13(3) of the Federal Reserve Act) during the financial crisis—notably, to prevent AIG and Bear Stearns from failing—was controversial. The Dodd-Frank Act modified Section 13(3) to restrict future intervention on behalf of a failing firm. Congress has debated whether to place additional restrictions on the use of Section 13(3). The Fed would like its emergency authority to be broad given the unpredictable nature of financial instability, but open-ended authority could potentially be used in ways that Congress did not intend, as the crisis illustrated.

**Governance.** Congress has debated changes to the Fed’s governance structure. Proposals include changing the voting balance between Fed governors and presidents on the FOMC; making the New York Fed president a presidential appointee; and changing how the regional bank directors and presidents are selected. Some Members of Congress have also expressed concern over a lack of diversity at the Fed. The Dodd-Frank Act created Offices of Minority and Women Inclusion throughout the Federal Reserve System.

**CRS Resources**

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

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

CRS Report R44185, Federal Reserve: Emergency Lending, by Marc Labonte

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