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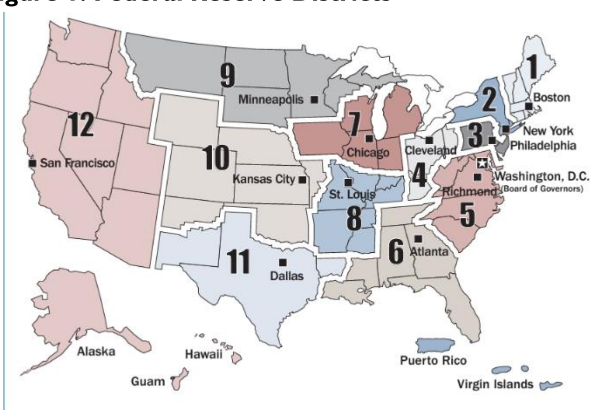
Introduction to Financial Services: The Federal Reserve

Structure of the Federal Reserve

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

The board is composed of seven governors nominated by the President and confirmed by the Senate. The President selects (and the Senate confirms) a chair and two vice chairs from among the governors, one of whom is responsible for supervision. The governors serve nonrenewable 14-year terms; the chair and vice chairs serve renewable four-year terms. There are no limits on how many board members may come from the same political party. The governors may be removed only "for cause," a higher standard than the "at will" removal standard that applies to most political appointees. Regional bank presidents are chosen by their boards with the approval of the Board of Governors.

Figure 1. Federal Reserve Districts



Source: Federal Reserve.

In general, Fed 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 authorization. The Fed is funded by fees and the income generated by securities it owns. Its income typically exceeds its expenses (although it has run losses since September 2022), and it remits most of its net income to the Treasury, where it is added to general revenues.

The Fed's capital consists of stock and a surplus. The surplus is capped at $6.825 billion by law. (Congress reduced the Fed's financial surplus as a budgetary "pay for" in P.L. 114-94, P.L. 115-123, and P.L. 115-174.) Private banks regulated by the Fed buy stock in the Fed to become *member banks*. Membership is mandatory for federally chartered banks but optional for state-chartered banks. The stock pays dividends of 6% for banks with less than $10 billion in assets and the lower of 6% or the 10-year Treasury yield for banks with more than $10 billion in assets. Member banks choose two-thirds of the board members at the regional Fed banks.

Responsibilities of the Federal Reserve

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

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

The Fed keeps the federal funds rate within a target range of 0.25 percentage points by setting two similar interest rates directly—the interest rate it pays banks on reserves held at the Fed and the interest rate it borrows from at its reverse repo facility. The Fed influences growth in the money supply through its control over bank reserves held at the Fed and currency in circulation, which are liabilities on its balance sheet. The assets held on its balance sheet are primarily Treasury securities and mortgage-backed securities (MBS). (In addition, monetary policy can involve foreign exchange operations, although this is rare.)

To stimulate the economy and keep markets liquid following the financial crisis and the COVID-19 pandemic, the Fed reduced the federal funds rate to zero and increased the size of its balance sheet through large-scale asset purchases of Treasury securities and MBS—known as *quantitative easing (QE)*. Following the pandemic, the balance sheet doubled in 18 months. Since June 2022, the Fed has been reducing the size of its balance sheet, but it remains much larger than before the pandemic.

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 sets the *discount rate* on these loans at the top of the federal funds rate range. In normal market conditions, the Fed's lending operations are minimal. In crises, such as the 2008 financial crisis and the COVID-19 pandemic, the Fed has created emergency facilities using emergency authority to extend its lender-of-last-resort function to nonbanks and markets.

Regulation. The Fed has rulemaking, supervisory, and enforcement powers to regulate bank holding companies (which include the largest banks), some foreign banks, and some state-chartered banks. Large banks are subject to enhanced prudential regulation administered by the Fed. The Fed's regulatory responsibilities overlap with those of other bank regulators—the Consumer Financial Protection Bureau, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency. The Fed shares responsibility for financial stability with the Financial Stability Oversight Council and its member regulators. The Fed participates in intergovernmental fora—such as the Financial Stability Board and the Basel Committee on Banking Supervision—with other U.S. agencies.

Payment systems. The Fed operates key interbank payment systems and oversees some private sector payment systems. The Fed launched FedNow, a real-time payment settlement system, in 2023. It also acts as the federal government's *fiscal agent*—federal receipts and payments flow through Treasury's accounts at the Fed.

Policy Issues

Mandate. Congress has delegated monetary policy responsibilities to the Fed but conducts oversight to ensure that 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. Policy proposals include eliminating the employment mandate and changing the inflation target from 2%. In 2025, the Fed plans to review its long-term monetary strategy. Some have questioned whether revisions to the strategy in 2020 contributed to the Fed's slow response to high post-pandemic inflation.

Monetary policy and inflation. From 1992 to 2021, inflation was consistently low and stable. From 2021 to 2023, inflation was unusually high. Concerned that the pandemic could undermine the recovery and initially viewing high inflation as transitory, the Fed waited until March 2022 to begin raising interest rates and to end its asset purchases. Playing catch-up, the Fed raised rates aggressively in 2022 and 2023, and inflation fell. Inflation was above 2% and below 3% in 2024, and unemployment rose but remained low. Although inflation was not quite back to target, the Fed began a series of rate reductions in September 2024 to make monetary policy less contractionary. Reducing rates reduces the risk that unemployment will rise further but increases the risk that inflation will remain above 2%.

Independence. The Fed is more independent from Congress and the Administration than most agencies are. Donald Trump has questioned that independence, and some have suggested that, in a break with tradition, he should remove current Fed leadership. Economists have justified the Fed's independence on the grounds that insulating monetary policy decisions from short-term political pressures results in better economic outcomes. There is an inherent trade-off, however, between independence and accountability. Congress uses its oversight powers to promote accountability. For example, the Fed chair and vice chair for supervision are statutorily required to testify semiannually before the committees of jurisdiction, and the committees regularly conduct other hearings on the Fed.

Central bank digital currency (CBDC). Some have called for the Fed to create a "digital dollar" or CBDC, which would have some of the characteristics of cryptocurrencies. The Fed has not taken a position on the desirability of a CBDC but "does not intend to proceed with issuance … without clear support from the executive branch and from Congress, ideally in the form of a specific authorizing law." Critics question whether CBDC is a solution in search of a problem. Policymakers have debated how to balance privacy and preventing illicit activity and whether individuals should be able to hold CBDC in personal accounts at the Fed. In the 118th Congress, the House passed H.R. 5403, which would have prohibited the issuance of CBDC without congressional authorization.

Climate change. Since 2020, the Fed joined the intergovernmental Network for Greening the Financial System, created two internal committees related to climate risk, oversaw a climate scenario analysis of large banks to quantify their exposure to climate risk, and issued joint final guidance with other banking regulators establishing a climate risk management framework for large banks. Some critics believe that the Fed should be doing more to combat climate change, such as "stress tests" linking banks' capital requirements to climate exposure. Other critics believe that climate change is outside of the Fed's mission and that the Fed lacks the tools to effectively address it.

Regulation. The optimal trade-off between the benefits and costs of financial regulation continues to be debated. Banks argue that they face too much regulatory burden, disadvantaging them compared to nonbank competitors, and critics argue that regulation is needed to ensure stable credit, consumer protection, and financial stability. Recent congressional debate has focused on the "Basel Endgame" capital proposal, which remains pending. Many in Congress have expressed concern about whether the Fed is susceptible to *regulatory capture*, the concept that regulated entities have undue influence over their regulators. For example, the Fed reported that it was too slow to take supervisory action against Silicon Valley Bank before its failure in 2023, which could be a symptom of regulatory capture or have other causes (e.g., bureaucratic inertia).

CRS Resources

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

CRS In Focus IF12147, *The Fed's Balance Sheet and Quantitative Tightening*

CRS In Focus IF11471, *Central Bank Digital Currencies*

CRS In Focus IF12655, *Federal Reserve's Discount Window: Policy Issues*

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