CRS INSIGHT

Federal Reserve: Dividends Paid to Commercial Banks

November 20, 2015 (IN10322)

Related Policy Issue

- Monetary Policy and the Federal Reserve

Related Authors

- Marc Labonte
- M. Maureen Murphy

Marc Labonte, Specialist in Macroeconomic Policy (mlabonte@crs.loc.gov, 7-0640)
M. Maureen Murphy, Legislative Attorney (mmurphy@crs.loc.gov, 7-6971)

Currently, the Federal Reserve (Fed) pays a 6% dividend on stock it has issued to commercial banks. As a "pay for" (budgetary offset), the Senate-passed highway trust fund bill (H.R. 22) would reduce the dividend to 1.5% for banks with more than $1 billion in assets. The Congressional Budget Office estimates that this provision would raise revenues by $17 billion over 10 years. Based on Fed data, 157 national banks and 121 state member banks have more than $1 billion in assets. (The House-passed version of H.R. 22 replaced the dividend cut with a provision eliminating the Fed's surplus.)

All nationally chartered commercial banks are required to, and state-chartered commercial banks have the option to, become member banks of the Federal Reserve System. In 2014, 1,065 national banks and 858 state banks were members. To finance the creation of the Fed, the Federal Reserve Act of 1913 required member banks to purchase stock issued by the Fed paying a dividend of 6%, which has not been changed since. Member banks are required to purchase ("pay in") stock equal to 3% of their capital, and the Fed has the option to call in an additional 3%. The Fed records paid-in stock as capital on its balance sheet. At the end of 2014, member banks had paid-in stock of $28.6 billion, for which they received $1.7 billion of dividends. Over the past 100 years, the Fed has cumulatively paid out $20.5 billion in dividends, which are subject to federal tax unless issued before March 1942.

The Fed is a self-financing agency that annually yields a profit (positive net income) that is used to pay dividends, add to its surplus, and make remittances to the Treasury, which reduce the federal budget deficit. In 2014, the Fed had profits of $101.3 billion, of which $96.9 billion were remitted to the Treasury. Presumably, a reduction in dividends would increase remittances.

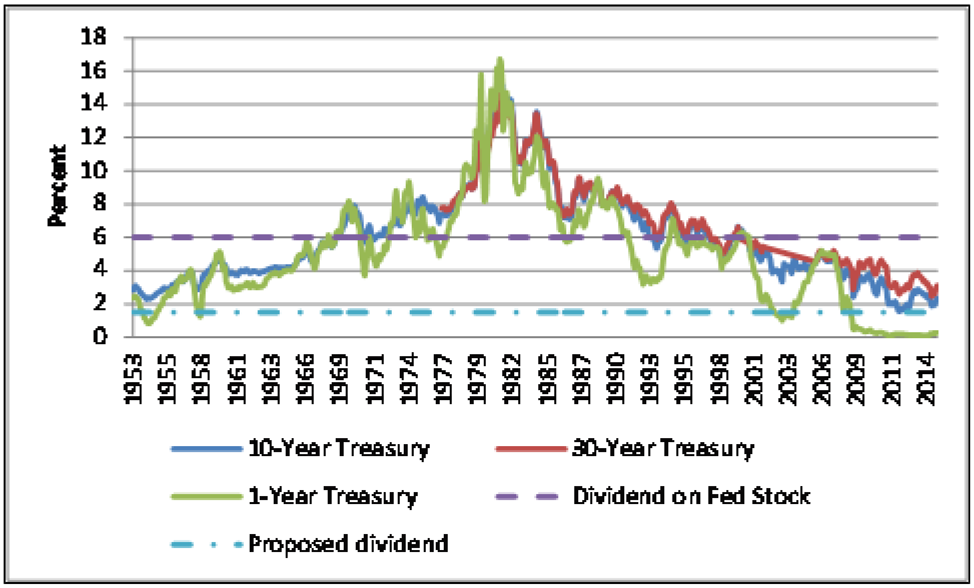
Ownership of stock in the Fed confers more limited rights than common stock in a private corporation. For example, stockholders have no control over Fed policy. The Fed is comprised of 12 regional banks, with each overseen by a Board of Directors. Member banks choose six of the nine directors on each board, three of whom are required to be from the banking industry. Membership also gives banks opportunities to advise the Fed through fora such as the Fed's

[Federal Advisory Council](). Giving banks a formal role in Fed governance arguably poses an inherent conflict of interest because the Fed regional banks supervise banks. Policies are in place to minimize the conflict of interest—directors from the industry do not participate in budget or personnel decisions, for example.

This stock can be thought of as a risk-free investment for member banks. Whether banks derive economic profits from these investments depends on market interest rates. Using Treasury rates as risk-free market rates, when Treasury rates are above 6%, banks earn a below-market rate of return on Fed stock; when rates are below 6%, banks earn an above-market rate of return. As can be seen in **Figure 1**, the dividend rate on Fed stock has been higher than all Treasury yields since 2000. By contrast, 10-year and 30-year Treasury yields were above 6% in most months from 1968 to 1997. The Congressional Budget Office projects that Treasury yields will remain below 6% over the next 10 years. By contrast, 10-year and 30-year Treasury yields have never been as low as 1.5% since 1953, whereas the one-year yield has been below 1.5% since 2008.

Figure 1. Yield on Treasury Securities and Dividend on Fed Stock

1953 to 2015



Source: Federal Reserve.

Any legal challenges to reducing the dividend rate would likely involve claims of breach of contract or uncompensated taking of property in violation of the Fifth Amendment's Takings Clause. A successful contract claim must show that the language of the statute has created a contractual obligation on the part of the government that cannot be altered by subsequent legislation without incurring liability. For a "takings" claim, a threshold issue would be whether the Fed stock and dividends are "property" for purposes of the Fifth Amendment.

Any claim would require a fact-intensive examination of the stock's characteristics in relation to an assessment of the legislative language. Important would be the precise effect that the legislation would have on the rights found to attach to the stock. One consideration is the voluntary nature of membership—state-chartered member banks may terminate their membership (which national banks may do if they convert to state charters), in which case, their Fed stock would be canceled and they would be reimbursed for their paid-in capital. Careful analysis would also be required of all of the provisions respecting entitlement to payment of a portion of the annual dividends when shares are surrendered before the end of the year.

A contract-based or takings claim would likely meet significant obstacles for success. For a takings claim, the courts would likely look to the three-factor balancing test that the Supreme Court uses in cases covering regulatory takings, particularly *Penn Central Transportation Co. v. City of New York*: (1) the economic impact of the government action; (2) the "extent to which the regulation has interfered with distinct investment-backed expectations;" and (3) the character of the governmental action. The courts have recognized relatively few governmental infringements of private property as constitutional takings where no outright seizure or permanent physical occupation of the property occurs—

that is, where the infringement is solely regulatory. The regulatory infringement must rise to a certain severity or be of a particular kind before courts will find a regulatory taking requiring "just compensation."

If Congress wanted to increase the share of profits remitted, there are two broad approaches. One approach would be to lower the statutory rate from 6%. Reducing the rate might make Fed membership less attractive to state banks. A lower dividend rate could be fixed or indexed to a market rate, as is the case for federal trust funds, so that the rate would rise and fall with inflation and other factors influencing interest rates.

Another approach would be for Congress to direct the Fed to buy out shareholders using its profits, which typically exceed the value of paid-in stock. Although this would reduce remittances to the Treasury in the first year, it would increase remittances in future years. Assuming a discount rate below 6%, this would be profitable for the government in net present value terms. Buying out bank shareholders would also address concerns about the conflict of interest of private ownership, but would require an alternative governance structure.