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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, as well as issues surrounding congressional oversight.

Monetary policy. The Fed has a statutory mandate of maximum employment and price stability. In normal conditions, the Fed conducts monetary policy by targeting the federal funds rate, a short-term interest rate. The Fed raised short-term interest rates from zero in March 2022 to a range of 5.25%-5.5% in July 2023 in an effort to reduce inflation, which has run well above the Fed's 2% inflation target since 2021. As inflation has fallen, economists have debated whether reducing interest rates in 2024 would be timely or premature and whether the Fed will be able to orchestrate a "soft landing" that avoids the economy entering a recession.

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 gradually reducing its size, with uncertainty about when that process will end. The Fed remits its net income to the Treasury, and higher interest rates have caused its net income to turn negative and its remittances to temporarily fall to zero.

Regulation. The Fed regulates bank holding companies, some state-chartered banks, and some U.S. operations of foreign banks. Large banks are subject to enhanced prudential regulation administered by the Fed. Congress is interested in a number of Fed regulatory issues. The failure of Silicon Valley Bank (SVB) in the spring of 2023 raised questions about whether the Fed's supervision of SVB was deficient and whether reduced regulatory requirements on large banks following the enactment of P.L. 115-174 contributed to its failure. The "Basel III endgame" proposed rule would strengthen capital requirements for large banks. The Fed's other current regulatory priorities include managing climate risk, the merger approval process, and crypto services offered by banks. H.R. 4763 would allow banks to provide custody services for crypto and other digital assets. S. 2860 would facilitate banking services for cannabis businesses that are in compliance with state laws.

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 system operators. In July 2023, the Fed introduced a real-time payment system, FedNow. In the 118th Congress, the House Financial Services Committee has considered legislation to prohibit the Fed from issuing a central bank digital currency or "digital dollar" (H.R. 5403) and to give the Fed jurisdiction over nonbank payment stablecoin issuers (H.R. 4766).

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 created emergency facilities to support the financial system during the pandemic. Borrowing—and problems with borrowing—by failed banks in 2023 have raised questions about its lender of last resort role. When SVB failed, the Fed created the Bank Term Funding Program to allow banks to access longer-term loans against the book value, as opposed to market value, of their assets.

Oversight. 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. S. 2190 and H.R. 3556 would require the Fed to provide more information on supervision, and H.R. 3556 would also require the Fed to provide more information on lending programs.

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Introduction

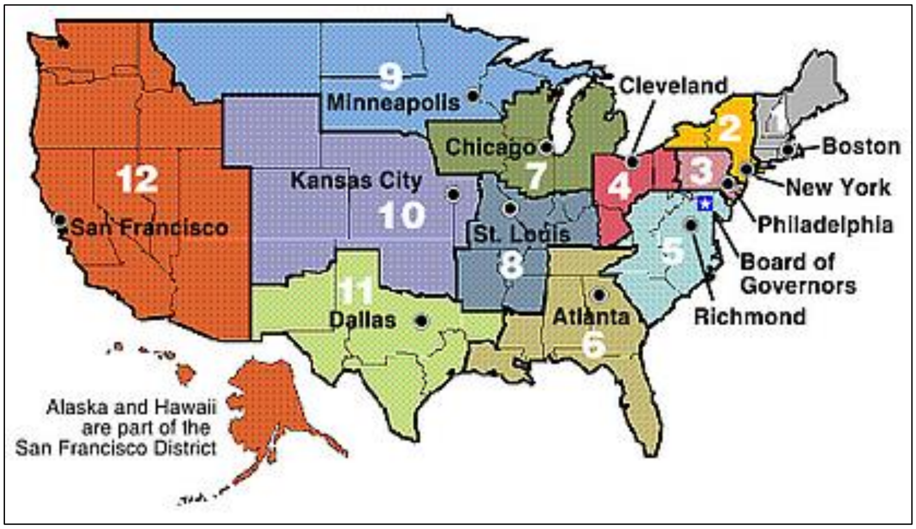
The Federal Reserve Act of 1913 (12 U.S.C. §§221 et seq.) created the Federal Reserve (Fed) as the nation's central bank. The Fed's responsibilities fall into four main categories: monetary policy, regulation of certain banks and other financial firms, provision and oversight of certain payment systems, 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 (such as monetary policy), which were more effectively carried out if centralized, led to a series of reforms in the early years 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 appellate 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.

The House Financial Services Committee ordered H.R. 3556 to be reported on May 24, 2023, which would, among other things, require the vice chair for supervision to have "primary experience working in, or supervising" banks and provide the other Fed governors a role in formulating regulatory policy. The current vice chair's experience is as a professor and former Treasury official specializing in financial regulation.

Policy issues for Congress going forward include the following:

[2] See the section entitled "Losses on the Fed's 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.

- 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?
- 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 Fed 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

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

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 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 Monetary 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

[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.

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. 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. The Fed did not create any expectation that repo market participants could rely on it to provide needed liquidity or remove excess liquidity from the market. (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. During the financial crisis and the pandemic, the Fed made very large amounts of repo funding available on an ad hoc basis to ensure markets stayed liquid. In 2021, the Fed added a standing repo facility to make it easier to keep the FFR from exceeding its target as it shrinks its balance sheet. But the facility also shifted the assurance that Fed repo funding would be available in times of need from an ad hoc to a permanent basis. The repo and reverse repo facilities, which fundamentally altered the functioning of a private lending market (by creating a permanent Fed backstop in the market), were created using existing authority without congressional approval or notice-and-comment rulemaking.

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[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.

[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).

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. PCE inflation (measured as the 12-month change) peaked above 7% in June 2022, its highest level in decades. Since then, it has gradually declined but remains above 2%. High inflation originated in a number of factors. On the supply side, these included supply chain disruptions and high commodity prices following the Russian invasion of Ukraine. On the demand side, these included strong consumer demand, in part because of the fiscal and monetary stimulus put in place during the pandemic. But regardless of why inflation is high, it can be reduced through policies that reduce demand or increase supply. Mainstream economists view monetary policy as the policy option that can reduce inflation most quickly and forcefully in practice, and so they view the ability to effectively reduce inflation to lay primarily with the Fed. In the words of Fed Chair Jerome Powell, "The 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 the zero lower bound 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 problem 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 had become high, widespread, and deeply embedded.

The Fed changed course beginning in 2022, raising rates repeatedly following each FOMC meeting from March 2022 to July 2023—by as much as 0.75 percentage points following some meetings—and beginning an ongoing gradual reduction of the balance sheet in June 2022.[13] By July 2023, rates were at their highest level since 2007.

The combination of improving supply chains, lower energy prices, and tighter monetary policy brought inflation down much closer to the Fed's 2% target, but it has remained above the target to date. The Fed has not implemented any additional rate increases since July 2023 and is assessing whether the tightening to that point would be sufficient to drive inflation back to its target. Recently, leadership has signaled that rates have likely peaked and has started discussing the possibility of reducing rates in 2024, perhaps before inflation has reached 2%. This could be viewed as risky, given how recently inflation was high, but monetary policy works with a lag, so the Fed wants to avoid overshooting its target. The Fed is hoping for a "soft landing," where inflation falls without triggering a recession. When the Fed was raising rates, many outside forecasters believed a recession or "hard landing" was more likely. In part, that is because there are few examples of large increases in interest rates that did not result in recession—and when they did, they involved smaller interest rate increases and a lower initial inflation rate. But so far,

[11] This section draws from other CRS products coauthored with Lida Weinstock.

[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 rates and not based its balance sheet reduction plans on the inflation rate.

economic activity has moderated without contracting,[14] and inflation looks to be on course to return to 2%, generating more optimism outside the Fed that a soft landing can be achieved.

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

- Can the Fed successfully restore price stability without further rate increases? Given lags in monetary policy's effects and the Fed's need to maintain inflation credibility, how low should inflation be when the Fed starts bringing interest rates back down?
- Can the Fed restore price stability without causing a recession? Given the lags in monetary policy effectiveness, have rates been raised too high to avoid a recession in the coming year? If the economy enters a recession before inflation has returned to 2%, how should the Fed respond?
- At what rate would tolerating higher inflation rate be preferable to policies that might result in higher unemployment?
- What can Congress do for U.S. businesses and households negatively affected by higher interest rates? Would actions to assist them make it harder to achieve price stability?
- Could price stability be restored more quickly if monetary tightening is accompanied by tighter fiscal policy? 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; and CRS In Focus IF12543, *Has the Federal Reserve Achieved a Soft Landing in 2023?*, by Lida R. Weinstock and Marc Labonte.

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)[15] acquired through open market operations and repos lent to the private sector through its Standing Repo Facility.[16] Its assets also include discount window loans and loans and assets held by its other emergency facilities. Its liabilities are primarily currency, reverse repos borrowed from the private sector, bank reserves held in master accounts at the Fed, and balances that Treasury holds at the Fed.[17] When the Fed purchases assets or makes loans, its balance sheet gets

[14] The economy contracted mildly in the first two quarters of 2022 (at the beginning of the period when the Fed was raising rates), but this was not officially classified as a recession, and the economy has grown at a moderate rate since then.

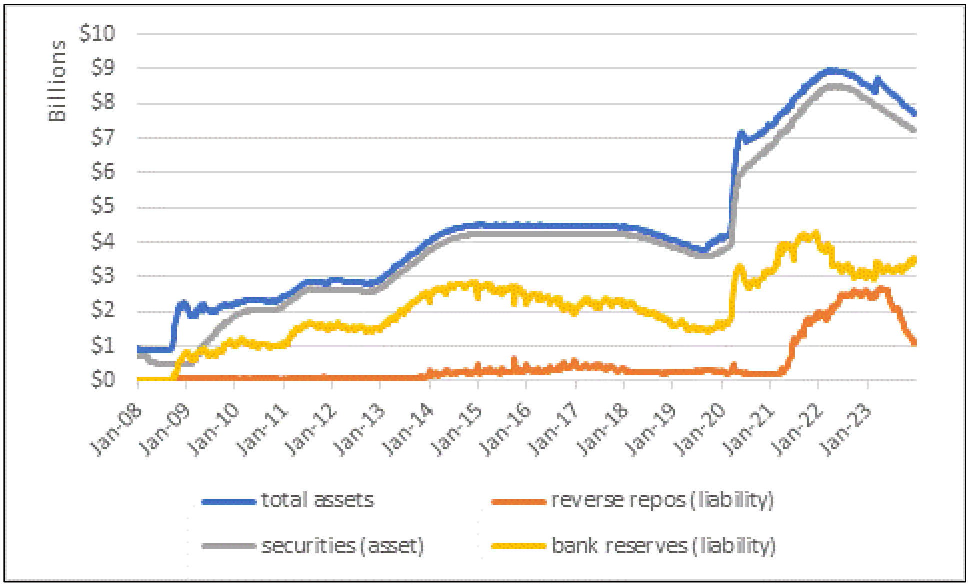
[15] By statute, the Fed can purchase only a narrow range of securities, notably securities issued or guaranteed by the federal government or a federal agency. Government-sponsored enterprises are considered federal agencies for this purpose, and they issue and guarantee MBS and other securities.

[16] 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.

[17] Reserves are assets held as liquid cash balances, as opposed to funds invested in loans or securities.

larger, which is matched predominantly by growth in two of its liabilities—reverse repos and bank reserves, as seen in **Figure 2**.

Figure 2. Selected Assets and Liabilities on Fed's Balance Sheet, 2008-2023



Source: Federal Reserve.

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 severe 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 this policy, popularly called QE, it purchased trillions of dollars of primarily Treasury securities and MBS in an effort to directly lower their yield.[18] As a result, the Fed's balance sheet grew significantly in three rounds of purchases from 2008 to 2014 and then again when it made purchases from 2020 to 2022, as shown in **Table 1**. The Federal Reserve's balance sheet expanded from $4.7 trillion in March 2020, to $7 trillion in May 2020, to a high of almost $9 trillion in May 2022.[19] 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. At that time, 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.

[18] 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.

[19] 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.

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
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.[20] (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—the Fed has no plans to sell securities currently. 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. In months where the amount of securities rolling off has exceeded the caps, the Fed has purchased assets to replace the excess amount. In months where fewer securities have rolled off than the cap amount, the balance sheet has shrunk by less than $95 billion.[21] At the end of 2023, the size of the balance sheet was about $7.7 trillion.

In statements in January and May 2022, the Fed laid out its long-term goals for the balance sheet.[22] 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,[23] 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

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

[21] Because the MBS held by the Fed are backed mostly by mortgages with interest rates that are lower than current market rates, borrowers have not been repaying or refinancing those mortgages at a high pace, causing MBS roll offs to be lower than the cap in most months. The Fed reported roll offs relative to the caps in Federal Reserve Bank of New York, *Open Market Operations During 2022*, April 2023, https://www.newyorkfed.org/medialibrary/media/markets/omo/omo2022-pdf. 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.

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

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

judges to be consistent with ample reserves." It has not yet indicated what it expects that level to be. When the wind-down is complete, it is unclear whether the Fed intends for the balance sheet to be larger than it was before the pandemic, when it was $4.2 trillion.

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?
- 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?
- How soon will the Fed stop shrinking its balance sheet? 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 through heavy use of its standing repo facilities?
- Have the Fed's MBS purchases contributed to making house prices rise 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?

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

Losses on the Fed's Balance Sheet

The Fed earns income on its loans, repos, and securities holdings, 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, similar to profits. 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 finance additional federal spending, they effectively make the budget deficit and federal debt smaller than they otherwise would be.

The Fed's balance sheet consists mostly of longer-term assets and very short-term liabilities. Typically, longer-term assets have higher yields than short-term liabilities do, so net income is positive. However, since September 2022, the Fed's interest expenses have exceeded its interest income, causing net income to be negative and remittances to temporarily fall to near zero.[24] Net income has been negative because interest rates rose sharply in 2022. As a result, the interest rate the Fed pays on bank reserves and reverse repos became higher than the yield on securities it acquired when interest rates were much lower. As discussed above, the Fed acquired large holdings of low-yielding securities through QE during the pandemic.[25] Interest expenses rose from $5.7 billion in 2021 to $102.4 billion 2022 to $281.1 billion in 2023.

Remittances have not been zero since 1934.[26] In 2023, they were effectively zero. The yield on the Fed's assets will eventually exceed the yield on its liabilities again because the Fed will reduce short-term interest rates or because low-yielding assets on the Fed's balance sheet will eventually mature and be replaced by higher yielding assets.[27] At that point, net income will become positive again, but projections suggest that may take a few years. One estimate projects that net income will be negative until 2025 and remittances will be effectively zero until 2027.[28]

Although Fed losses have reduced federal revenues since September 2022, cumulative federal revenues over time have still been larger than they would have been if the Fed had not expanded its balance sheet, which led to unusually large remittances from 2009 to 2022 (see **Figure 3**). Beginning in 2009, its net income and remittances increased significantly as a result of its balance sheet growth caused by QE and low short-term interest rates on its liabilities. Between 2009 and 2022, annual remittances were between $47 billion and $117 billion each year. Before 2009, the largest annual remittance ever was $35 billion. Moreover, this considers only the direct effect of QE on the federal budget. If QE returned the economy to full employment faster, that also had a positive indirect effect on the federal budget.

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[24] Net income and remittances for each of the 12 Federal Reserve banks is calculated individually. Because not all 12 banks had negative net income throughout 2023, a small balance was remitted to Treasury.

[25] For example, at the end of 2022, almost 80% of its MBS holdings were issued since 2020, and over 70% had coupon rates of 2.5% or lower. Federal Reserve Bank of New York, *Open Markets Operations During 2022*

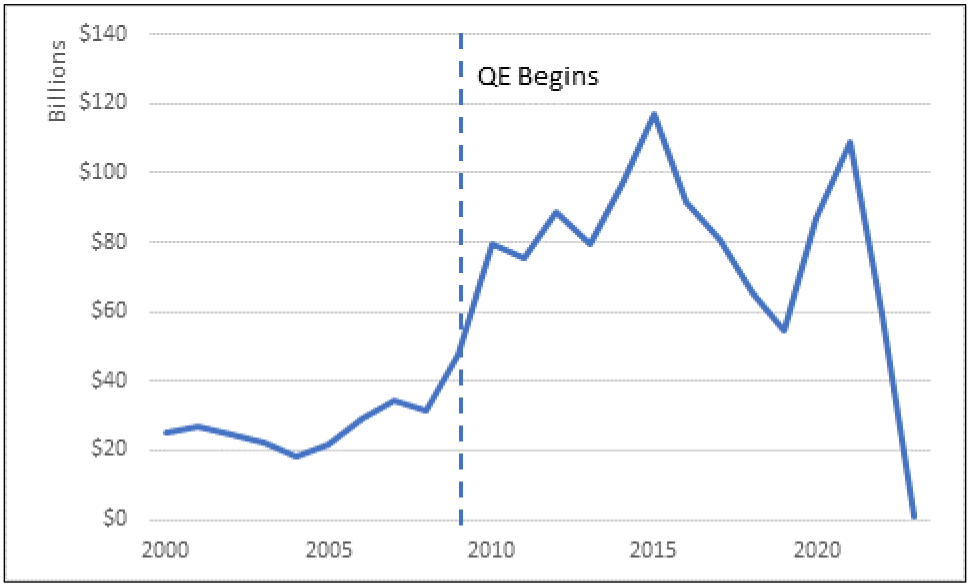
[26] In some years, remittances were statutorily required. In years with no statutory requirement, remittances were solely the result of positive net income. Federal Reserve, *Annual Report, 2022*, Table G.10, https://www.federalreserve.gov/publications/files/2022-annual-report.pdf.

[27] 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 its securities to maturity, as planned, the Fed will not realize any losses through sales of these securities, and the chance that these securities will suffer losses upon maturity is negligible.

[28] Miguel Faria e Castro and Samuel Jordan-Wood, "The Fed's Remittances to the Treasury: Explaining the 'Deferred Asset'," Federal Reserve Bank of St. Louis, November 21, 2023, https://www.stlouisfed.org/on-the-economy/2023/nov/fed-remittances-treasury-explaining-deferred-asset.

Figure 3. Fed Remittances to Treasury

2000-2023



Source: Federal Reserve, *Annual Report, 2022*, Table G.10, https://www.federalreserve.gov/publications/files/2022-annual-report.pdf; Federal Reserve, "Federal Reserve Board Announces Preliminary Financial Information for the Federal Reserve Banks' Income and Expenses in 2023," press release, January 12, 2024, https://www.federalreserve.gov/newsevents/pressreleases/other20240112a.htm.

Partly because of the statutory limit on its surplus, the Fed holds very little capital relative to its liabilities, and losses since September 2022 have been an order of magnitude larger than its entire surplus. But unlike a private company, the Fed does not reduce its capital, become insolvent, or require a capital infusion to maintain solvency in response to losses. Instead, under its accounting conventions, it registers the losses as a deferred asset. At the end of 2023, the deferred asset was $133 billion. Positive net income in future years would be directed to eliminating this deferred asset instead of being remitted to Treasury. Thus, positive net income will resume before remittances do.

Private companies hold capital to prevent losses from causing insolvency. But unlike with a private company, the Fed's recent losses—which exceed its capital—have not affected its ability to honor its liabilities, and its creditors cannot compel it to declare bankruptcy. The Fed is not a profit-maximizing institution—its remittances are a byproduct of monetary policy, not the metric to judge the success of monetary policy. Losses are a sign not of mismanagement but that its interest-bearing liabilities had higher yields than its interest-bearing assets did. Losses since 2022 have not reduced the confidence of market participants and do not seem to have affected the Fed's political independence. If the Fed based monetary policy on concerns about its profits and losses, it would detract from achieving its statutory mandate of maximum employment and stable prices.

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 ultimately result in losses (e.g., by purchasing short-term instead of long-term securities)?

- To reduce the possibility of future losses, should the Fed revert to the scarce reserves operating framework in place before 2008 so that it does not need to pay interest on reserves and reverse repos in order to target interest rates?[29]
- Should the Fed use conventional accounting standards that would increase transparency surrounding its financial condition but would require it to accumulate more capital (through reduced remittances) to absorb potential losses? Or would conventional accounting standards be inappropriate given its unique financial status?
- Should Congress raise the statutory limit on the Fed's surplus to increase the Fed's capital stock if it is concerned about losses? Alternatively, should Congress eliminate the surplus entirely to avoid further use of the surplus as a "pay for" for unrelated policy changes?[30]

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 its statutory mandate 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*.[31] 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.[32] One rationale for the 2020 revisions was the weak relationship between unemployment and inflation in previous years. Since

[29] If the Fed reverted to its pre-2008 framework for conducting monetary policy, average profits would be lower, but losses would also be less likely.

[30] Previous efforts by Congress to prohibit the use of the surplus as a budgetary 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.

[31] 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.

[32] 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; Gauti B. Eggertsson and Don Kohn, "The Inflation Surge of the 2020s: The Role of Monetary Policy," Brookings Institution, August 2023, https://www.brookings.edu/wp-content/uploads/2023/07/WP87-Eggertsson-Kohn_7.25.pdf.

2021, the relationship seemed to strengthen again, as very low unemployment coincided with very high inflation.

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.

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, but the Fed does not seem better or worse than its international peers at avoiding recessions. 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.[33] Others believe that full employment should get more weight and price stability less.[34] 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. (A pure price level target, unlike the Fed's inflation target, would require a period of deflation to reverse price rises that occur during periods of high inflation.) Other economists argue that discretionary monetary policy should be replaced or reduced by a focus on monetary policy rules[35]—that is, mathematical formulas that prescribe how interest rates should be set based 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 types 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:

[33] 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/.

[34] 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.

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

- 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 recent 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 target, or a policy rule be more effective, or would those measures needlessly complicate monetary policymaking and reduce public understanding of the Fed's intentions?

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 regulates bank holding companies (BHCs) and thrift holding companies—parent companies that own nearly all large and most small depositories—for safety and soundness and other bank regulatory requirements.[36] The Fed is also the primary prudential regulator of state-chartered banks that have elected to become members of the Federal Reserve System and most types of U.S. operations of foreign banking organizations. Often in concert with the other banking regulators,[37] 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 has rulemaking, supervisory, and enforcement authorities to carry out its regulatory responsibilities, and many policy issues involve recent and forthcoming actions using those authorities. The Fed's supervisory authority includes consumer protection compliance

[36] 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.

[37] The federal banking regulatory system is charter based. Federally chartered (national) commercial banks are regulated by the Office of the Comptroller of the Currency (OCC), and state-chartered commercial banks that do not join the Federal Reserve System are regulated by the Federal Deposit Insurance Corporation (FDIC). National banks are required to become members of the Fed, and state banks have the option of becoming members, but the Fed is the primary regulator of only the latter. 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.

for banks under its jurisdiction that have $10 billion or less in assets.[38] The Fed set minimum reserve requirements for all banks until 2020, when the Fed permanently set them at zero.[39]

The Fed has also historically had a focus on maintaining financial stability, which the Dodd-Frank Act made the primary responsibility of the Financial Stability Oversight Council (FSOC), with certain new duties assigned to the Fed.[40] For example, under the Dodd-Frank Act the Fed regulates large BHCs and systemically important financial institutions for systemic risk, as discussed in the next section.

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

The Fed finalized two notable rules in 2023. In October, it finalized a joint rule with the banking regulators to modernize the Community Reinvestment Act.[41] Separately in October, it finalized a rule implementing capital standards for insurance companies under its jurisdiction.[42] (Currently, the Fed regulates six thrift holding companies that own insurance subsidiaries.) The Fed also proposed rules in 2023 on automated valuation models for real estate[43] (jointly with other agencies) and interchange fees for debit transactions,[44] as well as some proposals affecting large banks that are discussed in the next section. In addition, there are a number of ongoing regulatory issues of interest to Congress covered in the following sections.

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

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[38] 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.

[39] Their removal is related to the shift to the "abundant reserves" monetary framework discussed below. 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.

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

[41] Federal Reserve, FDIC, OCC, "Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Agencies Issue Final Rule to Strengthen and Modernize Community Reinvestment Act Regulations," joint press release, October 24, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231024a.htm.

[42] Federal Reserve, "Federal Reserve Board Finalizes a Rule Establishing Capital Requirements for Insurers Supervised by the Board," press release, October 06, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231006a.htm.

[43] Board of Governors of the Federal Reserve System, CFPB, FDIC, Federal Housing Finance Agency, National Credit Union Administration, and OCC, "Agencies Request Comment on Quality Control Standards for Automated Valuation Models Proposed Rule," joint press release, June 1, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230601a.htm.

[44] Federal Reserve, Federal Reserve Board Requests Comment On A Proposal To Lower The Maximum Interchange Fee That A Large Debit Card Issuer Can Receive For A Debit Card Transaction, Press Release, October 25, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231025a.htm.

the 2010 Dodd-Frank Act (P.L. 111-203) aimed to increase financial stability and end TBTF by creating an enhanced prudential regulatory (EPR) regime administered by the Fed that applies to large banks and to nonbank financial institutions designated by FSOC as systemically important financial institutions (SIFIs).[45] Since enactment, the number of designated nonbank firms has ranged from four to none today.[46]

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.
- **Resolution plans ("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.
- **Risk management** standards 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** require large banks to hold more capital than other banks to potentially absorb unforeseen losses. These include the **supplementary leverage ratio**. Banks that have been designated as global systemically important banks (G-SIBs) by the Financial Stability Board must also meet a **G-SIB capital surcharge**. Stress test results determine how much capital large banks must hold through the **stress capital buffer**.

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, the Economic Growth, Regulatory Relief, and Consumer Protection Act (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. G-SIBs and banks that 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 Fed's 2019 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.[47] The rule also applied EPR to foreign banks with large U.S. operations and large savings

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

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

[47] 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, (continued...)

and loan (thrift) holding companies that are not predominantly engaged in insurance or nonfinancial activities.[48]

The Fed's new vice chair for supervision, Michael Barr, conducted a "holistic capital review" of requirements applying to large banks from 2022 to 2023, which resulted in several recommended changes.[49]

Currently, the Fed has several proposed rules outstanding, in some cases issued jointly with other bank regulators, that would modify large bank regulatory requirements:

- In 2018, the Fed and the Office of the Comptroller of the Currency (OCC) proposed a rule to incorporate the G-SIB surcharge into the enhanced supplementary leverage ratio for G-SIBs. It has not been finalized.[50]
- The federal banking regulators issued a joint proposal to implement the "Basel III Endgame" in July 2023 for banks with $100 billion or more in assets, discussed in more detail below.
- On the same day, in a separate proposal, the Fed proposed changing how the G-SIB surcharge is calculated.[51]
- In August 2023, the banking regulators proposed subjecting all banks with $100 billion or more in assets to long-term debt requirements and clean holding company requirements to facilitate orderly liquidation in the event of the bank's failure.[52]

Policy issues going forward include the following:

- 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? If so, are complementary or alternative policy approaches needed to address TBTF?
- Did the 2019 changes to EPR better tailor EPR to match the risks posed by large banks? Or did these changes allow additional systemic and taxpayer risk that outweigh the benefit of reduced regulatory burden, especially if the benefits have

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.

[48] 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.

[49] Vice Chair for Supervision Michael S. Barr, "Holistic Capital Review," speech at the Bipartisan Policy Center, July 10, 2023, https://www.federalreserve.gov/newsevents/speech/barr20230710a.htm.

[50] OCC, Federal Reserve, "Regulatory Capital Rules," 83 *Federal Register* 17317, April 19, 2018, https://www.govinfo.gov/content/pkg/FR-2018-04-19/pdf/2018-08066.pdf.

[51] The proposal was published in the *Federal Register* in September 2023. Federal Reserve, "Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15)," 88 *Federal Register* 60385, September 1, 2023, https://www.govinfo.gov/content/pkg/FR-2023-09-01/pdf/2023-16896.pdf.

[52] OCC, Federal Reserve, and FDIC, "Long-Term Debt Requirements for Large Bank Holding Companies, Certain Intermediate Holding Companies of Foreign Banking Organizations, and Large Insured Depository Institutions," 88 *Federal Register* 64524, September 19, 2023, https://www.govinfo.gov/content/pkg/FR-2023-09-19/pdf/2023-19265.pdf. The proposal also makes technical changes to the TLAC rule. For a comparison, see Davis Polk, "Comparison of the Long-Term Debt Proposal to the Existing TLAC Rule," September 5, 2023, https://www.davispolk.com/sites/default/files/2023-09/comparison-of-LTD-proposal-and-TLAC-rule.pdf.

mainly accrued to the affected banks? Does the failure of three large banks in the spring of 2023 (discussed below) warrant a reevaluation of EPR?

For more information, see CRS Report R47876, *Enhanced Prudential Regulation of Large Banks*, by Marc Labonte.

Basel III Endgame[53]

Setting bank capital requirements is an iterative process. Requirements have repeatedly been tweaked over the decades as problems emerge or policy priorities change. For example, in 2013 U.S. regulators began implementing "Basel III," a new capital framework aimed at addressing many of the issues believed to precipitate the global financial crisis that was negotiated by the Basel Committee on Banking Supervision (BCBS), an international standard-setting body. A set of BCBS recommendations from 2017 fill in some of the more technical details of Basel III and are sometimes colloquially referred to as the *Basel III Endgame*.[54]

On July 27, 2023, the federal banking regulators jointly issued a proposed rule that would revise large bank capital requirements.[55] In addition to implementing the Basel III Endgame, the proposal would implement (1) some of the recommendations that Fed Vice Chair Barr proposed in a previous holistic capital review, and (2) certain changes responding to issues that arose when three large banks failed in 2023. The proposal would apply to banks with over $100 billion in assets—a threshold exceeded by all three failed banks. According to the proposal, its purpose is to improve the consistency of capital requirements across banks, better match capital requirements to risk, reduce their complexity, and improve transparency of banks' financial conditions for supervisors and the public.

In the United States, Category I and II banks (under the Fed's 2019 rule implementing P.L. 115-174, as discussed above) are currently required to calculate their requirements using two methods: a standardized approach applicable to all banks and a specialized *advanced approach* that allows the banks to model many of their own risks. Although internal models can potentially be "gamed" (i.e., designed in a way to allow a bank to hold less capital rather than accurately measure risk), they can also model risk more sophisticatedly and be more tailored to a bank's unique risk profile. Following the Basel III Endgame, the proposed rule would reduce the use of internal models through a new second standardized approach for advanced approaches banks called the *expanded risk-based approach*. Other banks with over $100 billion in assets would be required to calculate risk-weighted assets under two approaches for the first time. Despite the regulators' intentions to reduce complexity, many within the industry have criticized this dual approach to capital requirements as unduly burdensome.

The proposal would also require banks with over $100 billion in assets to include unrealized capital gains and losses on available-for-sale debt securities in their capital levels. Unrealized capital losses were one of the primary causes of Silicon Valley Bank's failure.[56] The proposal would also extend two capital requirements—the supplementary leverage ratio and countercyclical capital buffer—to all banks with over $100 billion in assets.

[53] This section draws from other CRS products coauthored with Andrew Scott.

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

[55] OCC, Federal Reserve, and FDIC, "Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking Organizations with Significant Trading Activity," 88 *Federal Register* 64028, September 18, 2023, https://www.govinfo.gov/content/pkg/FR-2023-09-18/pdf/2023-19200.pdf. A summary, fact sheet, and overview are available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230727a.htm.

[56] See the section entitled "Silicon Valley Bank (SVB) Failure."

One criticism of the proposal is that it is not capital neutral but, rather, would require subjected banks to hold more capital. Although the proposal does not raise required capital ratios, the regulators estimate that its effect on risk-weighted assets would increase the average binding common equity capital level large banks are required to hold by 16%. Note that (1) this estimate is an average, and the effects on any particular bank would differ; and (2) this is an estimate based on past data—the actual effect would depend on future actions by the banks, including how they responded to the rule. The proposal would have a larger capital effect on trading activities than on lending, and it is estimated to have the largest effect on G-SIBs.

Policy issues going forward include the following:

- Is it appropriate to change capital standards in such a way that large banks are required to hold more capital overall, or is the banking system already well capitalized? How would the proposal affect their competitiveness with small banks and nonbank financial firms? Would the proposal make the financial system safer or needlessly restrict credit?
- Have domestic deviations from Basel standards led to inappropriate "gold plating" of capital requirements? Does the requirement that large banks comply with two sets of capital standards add unduly burdensome complexity, or does it ensure a level playing field with smaller banks?
- Is the proposal appropriately tailored by exempting banks with under $100 billion in assets? Or should it be further tailored to treat banks near the $100 billion threshold differently from G-SIBs?
- Would the proposed changes to the risk weights have negative effects on specific sectors or activities, such as mortgage lending, activities with fee-based income, trading activities, and tax equity renewable energy projects?
- 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 rulemaking process improperly 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? Should the bank regulators have publicly provided more analysis independent of BCBS's to justify the proposal?

For more information, see CRS Report R47855, *Bank Capital Requirements: Basel III Endgame*, by Marc Labonte and Andrew P. Scott.

Silicon Valley Bank (SVB) Failure

The spring of 2023 featured the second (First Republic), third (SVB), and fifth (Signature) largest bank failures in U.S. history (as measured by asset size in nominal dollars).[57] Combined, these failures are expected to ultimately impose over $30 billion in losses on the Federal Deposit Insurance Corporation (FDIC).[58] To prevent the first two failures from causing a broader run on

[57] CRS analysis of data from FDIC, "BankFind Suite," https://banks.data.fdic.gov/. In addition, the failure of Credit Suisse, a foreign G-SIB, was avoided through a Swiss-government-assisted takeover by UBS in the spring of 2023.

[58] FDIC, Office of Inspector General, *Material Loss Review of First Republic Bank*, November 28, 2023, https://www.fdicoig.gov/reports-publications/bank-failures/material-loss-review-first-republic-bank; FDIC, "Final Rule on Special Assessment Pursuant to Systemic Risk Determination," November 16, 2023, https://www.fdic.gov/news/financial-institution-letters/2023/fil23058.html.

the banking system, the FDIC invoked its rarely used systemic risk exception to guarantee all uninsured depositors at those two banks.[59]

Of the three failed institutions, only SVB was subject to EPR and had the Fed as its primary regulator, because Signature and First Republic were not members of the Federal Reserve system and because EPR does not apply to banks that are not structured as BHCs.[60] A post-mortem report by the Fed attributes SVB's failure to poorly managed interest rate risk, liquidity risk (in its case, an overreliance on uninsured deposits), and concentration risk (a lack of diversification in its customers and portfolio). Its risk management capacity did not keep pace with its rapid growth.[61]

Members of Congress debated whether P.L. 115-174 and the Fed's implementing rule in 2019 contributed to SVB's failure, which was sudden, unexpected, destabilizing, and disorderly—what EPR is intended to prevent.[62] The answer to that question depends primarily on whether this episode was a failure of regulation (inadequate safety and soundness rules), supervision (faulty application of existing rules by supervisors), or both. (Fed Vice Chair Barr testified that "I think that anytime you have a bank failure like this, bank management clearly failed, supervisors failed, and our regulatory system failed."[63]) EPR imposes regulatory standards but not supervisory standards. At its own discretion, the Fed has also tiered supervision by size and complexity, and the Fed has chosen to align its supervisory programs with the EPR thresholds both before and after they were changed by P.L. 115-174.[64]

Large banks face quantitative liquidity and capital rules under EPR. P.L. 115-174 raised the mandatory EPR threshold from $50 billion to $250 billion in assets, which is the level that the Fed chose to apply certain requirements—or more stringent versions of other requirements—to banks with over $250 billion or other metrics of systemic importance. Because SVB was under $250 billion in assets when it failed, it was never subject to these requirements. P.L. 115-174 gave the Fed discretion to apply tailored requirements to banks with $100 billion to $250 billion in assets, and the Fed applied some less stringent requirements at that threshold. SVB had over $100 billion in assets in 2020, but the Fed phased in compliance with those requirements slowly when a bank crossed the threshold, so SVB was never subject to any EPR requirements before it failed. Even if it had been subject to these rules, it is questionable whether most of them would have addressed the specific causes of SVB's failure.[65]

Interest rate risk could potentially have been captured earlier by a Basel III large bank requirement (as opposed to a Dodd-Frank EPR requirement) to recognize unrealized losses on available-for-trade debt securities in regulatory capital. Under the Fed's rule implementing P.L. 115-174, banks and BHCs that were not Category I or II banks and did not have significant

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[59] See CRS In Focus IF12378, *Bank Failures: The FDIC's Systemic Risk Exception*, by Marc Labonte.

[60] Fed discount window lending to SVB is discussed in the section below entitled "Discount Window Lending to Failed Banks in 2023."

[61] Federal Reserve, *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank*, April 2023, https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf.

[62] See, for example, U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *Examining the Failures of Silicon Valley Bank and Signature Bank*, 118th Cong., 1st sess., May 16, 2023; U.S. Congress, House Committee on Financial Services, *The Federal Regulators' Response to Recent Bank Failures*, 118th Cong., 1st sess., March 29, 2023.

[63] House transcript, available at https://www.bgov.com/next/news/RSCEQ5073NCW.

[64] Board of Governors of the Federal Reserve System, "Large Financial Institution Rating System Regulations K and LL," 83 *Federal Register* 58724, November 21, 2018, https://www.govinfo.gov/content/pkg/FR-2018-11-21/pdf/2018-25350.pdf.

[65] For more information, see the section entitled "Role of EPR in 2023 Bank Failures" in CRS Report R47876, *Enhanced Prudential Regulation of Large Banks*, by Marc Labonte.

foreign exposures could opt out of this requirement, which SVB did. The Fed reports that under the pre-P.L. 115-174 framework, SVB would have been required to recognize unrealized losses as of the second quarter of 2020.[66] Had unrealized capital losses been recognized, it would have reduced SVB's capital under one measure by $1.9 billion at the end of 2022, but SVB would have remained well capitalized even with this loss. Further, most of SVB's unrealized losses were associated with *held-to-maturity* assets, which do not have to be recognized in capital under current (or proposed) rules.

At the same time, many of the most important regulatory and supervisory standards applied to large banks are not the product of EPR—they apply to all banks. Interest rate risk, concentration risk, liquidity risk, and risks associated with rapid growth are not unique to SVB or large banks. These are all standard risks facing banks that prudential regulation is intended to keep in check, and regulators have a long history of supervising all banks for them. For example, Aaron Klein, senior fellow at the Brookings Institution, noted "at least four classic red flags of the bank's conduct that should have sent the alarm bells ringing."[67]

In terms of supervision, the Fed's SVB report details how "SVB's foundational problems were widespread and well-known, yet core issues were not resolved, and stronger oversight was not put in place." When SVB failed, it had 31 outstanding Matters Requiring Attention (MRAs) and Matters Requiring Immediate Attention (MRIAs) issued by Fed examiners regarding safety and soundness, risk management, liquidity, interest rate risk, and technology.[68] Some are on topics directly linked to the reasons for SVB's failure, such as six on liquidity risk issued in November 2021 (and still outstanding at the time of its failure). Several outstanding MRIAs dated back to 2020 or 2021. Since 2019, 54 MRAs and MRIAs had been issued in those areas. Nonetheless, Fed supervisors assigned ratings that "did not fully reflect [SVB's] vulnerabilities." For example, SVB did not receive a deficient rating in any area until 2022. The deficient rating should have triggered a formal enforcement action but did not. The report attributes these supervisory failings to SVB's rapid growth resulting in a slow transition to the heightened supervision applied to large banks, a reduction in supervisory hours spent on SVB, and a perception by examiners that there was "an informal shift in tone" from the Fed vice chair of supervision at the time[69] that led to "pressure to reduce burden on firms, meet a higher burden of proof for a supervisory conclusion, and demonstrate due process when considering supervisory actions."[70]

Congress has largely deferred to the Fed on its supervisory practices in the past, reflecting its status as a highly independent, self-funded agency. In response to SVB's failure, the Senate Banking Committee reported S. 2190 on June 22, 2023, which would, among other things, make it easier for regulators to claw back executive compensation from failed banks and enhance reporting requirements for Fed supervision. The House Financial Services Committee ordered

[66] Under the previous framework, SVB would have had to recognize unrealized losses, because it would have been considered an advanced approaches bank on account of having more than $10 billion in foreign exposure.

[67] Aaron Klein, "SVB's Collapse Exposes the Fed's Massive Failure to See the Bank's Warning Signs," Brookings Institution, March 16, 2023, https://www.brookings.edu/opinions/svbs-collapse-exposes-the-feds-massive-failure-to-see-the-banks-warning-signs/.

[68] Key supervisory findings, referred to as Matters Requiring Attention (MRAs), are required to be included in all supervisory communication documents, and the examiner is required to discuss any outstanding MRAs in the supervisory report. Crucially, examiners are required to specify a time frame for the bank to complete corrective action. Some findings are more critical and urgent to address and are considered Matters Requiring Immediate Attention (MRIAs).

[69] Randal Quarles was vice chair for supervision from October 2017 to October 2021 and continued as governor until December 2021. Michael Barr became vice chair in July 2022.

[70] Federal Reserve, *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank*, April 2023, https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf.

H.R. 3556 to be reported on May 24, 2023, which would, among other things, enhance reporting requirements for Fed supervision. (For more information, see the section below entitled "Fed Independence and Congressional Oversight.")

Policy issues going forward include the following:

- Should Congress revisit the scope or applicability of EPR, such as the asset threshold for mandatory application of EPR, following the large bank failures of 2023?
- Should the regulatory treatment of uninsured deposits or unrealized losses on securities be changed in light of the 2023 bank failures? Would the Basel Endgame proposal go far enough or too far in addressing unrealized losses?
- In light of supervisory shortcomings identified by the Fed in SVB's failure, should Congress defer to the Fed on strengthening supervisory practices or take a more active role? Does Congress have sufficient aggregate information about bank supervision to support its oversight role?

For more information, see CRS Insight IN12129, *Silicon Valley Bank, Signature Bank, and P.L. 115-174: Part 1 (Background and Policy Options)*, by Marc Labonte; CRS Insight IN12130, *Silicon Valley Bank, Signature Bank, and P.L. 115-174: Part 2 (Issues Surrounding Their Failures)*, by Marc Labonte; CRS Insight IN12232, *Banks' Unrealized Losses, Part 2: Comparing to SVB*, by Marc Labonte; CRS In Focus IF12454, *Bank Failures and Congressional Oversight*, by Marc Labonte.

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.[71] Building on existing regulatory practices, in October 2023, the Fed and other banking regulators issued joint guidance that provides "a high-level framework for the safe and sound management of exposures to climate-related financial risks" for banks with over $100 billion in assets. According to the regulators, "The final principles neither prohibit nor discourage large financial institutions from providing banking services to customers of any specific class or type."[72]

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

[71] 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.

[72] Federal Reserve, FDIC, OCC, "Agencies Issue Principles for Climate-Related Financial Risk Management for Large Financial Institutions," joint press release, October 24, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231024b.htm.

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 2023, the six largest banks participated in a Fed-led pilot "climate scenario analysis" to "help identify potential risks and promote risk management practices."[73] This exercise does not have any implications for capital requirements or supervision.

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 threat to financial stability and made a number of recommendations for agency actions, which include the actions the Fed has taken to date.[74]

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. They are also concerned that climate risk policies will unfairly steer credit away from fossil fuel industries. They argue that climate change policy is best addressed by Congress and that a focus on climate change distracts the Fed from its mission.

Policy issues for Congress going forward include the following:

- 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?

Mergers[75]

Mergers and acquisitions (M&As) involving banks—or, more technically, insured depository institutions—must comply with a number of statutory requirements.[76] 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,

[73] Federal Reserve, "Federal Reserve Board Provides Additional Details on How Its Pilot Climate Scenario Analysis Exercise Will Be Conducted and the Information on Risk Management Practices That Will Be Gathered over the Course of the Exercise," press release, January 17, 2023, https://www.federalreserve.gov/newsevents/pressreleases/other20230117a.htm.

[74] 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.

[75] This section draws from other CRS products coauthored with Andrew Scott.

[76] 12 U.S.C §1841 et seq and 12 U.S.C. §1828.

approval by more than one regulator can be required.) Most of the largest U.S. banks are structured as BHCs.[77]

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 their effects on market power in both national and local markets under joint guidelines developed in 1995.[78] DOJ has the authority to block an M&A on antitrust grounds.[79] It is not uncommon for a bank to divest branches before an M&A is approved to allay concerns about market power.[80] 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 Community Reinvestment Act. The M&A approval process is one of regulators' main tools to encourage compliance with the act.[81]

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 (AML)**—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, on May 1, 2023, the FDIC announced that JPMorgan Chase acquired First Republic through a purchase and assumption agreement after First Republic was taken into FDIC receivership.[82] Because the acquisition was a purchase and

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[77] 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 state regulators to block M&As only on limited grounds.

[78] Department of Justice, "Bank Merger Competitive Review—Introduction and Overview (1995)," https://www.justice.gov/atr/bank-merger-competitive-review-introduction-and-overview-1995.

[79] This authority resulted from a 1963 Supreme Court case, *United States v. Philadelphia National Bank*, 374 U.S. 321. See Assistant Attorney General Jonathan Kanter, keynote address at "Promoting Competition in Banking," event at the Brookings Institution's Center on Regulation and Markets, June 20, 2023, https://www.justice.gov/opa/speech/assistant-attorney-general-jonathan-kanter-delivers-keynote-address-brookings-institution.

[80] For example, on 16 occasions between 2006 and 2017, the Fed required M&A applicants to sell off branches. 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.

[81] 12 U.S.C. §2901 et seq. For more information on the act, see CRS Report R43661, *The Effectiveness of the Community Reinvestment Act*, by Darryl E. Getter.

[82] FDIC, "JPMorgan Chase Bank, National Association, Columbus Ohio Assumes All the Deposits of First Republic Bank, San Francisco, California," press release, May 1, 2023, https://www.fdic.gov/news/press-releases/2023/pr23034.html.

assumption of a failing bank, the competition requirements and the concentration limit were waived.[83]

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."[84] No plan was released in that time frame. In September 2022, Vice Chair Barr announced that the Fed was reviewing its approach to approving bank mergers, which may lead to future rulemaking.[85]

Congress has been interested in mergers among large banks in recent years, particularly how they might affect competition. There are 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" 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 the third quarter of 2023, the number of FDIC-insured institutions (which includes commercial banks and savings associations) fell from 9,613 to 4,614. One potential explanation for continued consolidation is that growing bank use of information technology creates greater economies of scale.

Most mergers involve small banks,[86] 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 2023 has acquired or applied to acquire a bank 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.[87]

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[83] See OCC, letter to JPMorgan Chase Bank, May 1, 2023, https://www.occ.treas.gov/topics/charters-and-licensing/app-by-jp-morgan-chase-bank.pdf.

[84] 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/.

[85] 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.

[86] FDIC, "Community Bank Mergers Since the Financial Crisis: How Acquired Community Banks Compared with Their Peers," *FDIC Quarterly*, vol. 11, no. 4 (2017), https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2017-vol11-4/fdic-v11n4-3q2017-article2.pdf.

[87] For example, in 2023, TD Bank and First Horizon withdrew their merger application after a prolonged delay when they became convinced that approval would not be forthcoming soon. See Jim Dobbs, "First Horizon, TD Bank Call Off Long Delayed Merger," *American Banker*, May 4, 2023, https://www.americanbanker.com/news/first-horizon-td-
(continued...)

Because the merger application process is iterative, it can be lengthy, and other critics complain that it is too slow and vulnerable to interference from outside groups. 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? Are regulators transparent about why some mergers are delayed or never approved? Does the "convenience and needs of the community" factor allow special interests to extract unrelated community benefit plans from the merging banks that are not officially required?
- 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 offering services related to cryptocurrencies and other digital assets (crypto).[88] Participation could take the form of traditional banks providing some types of cryptocurrency services or cryptocurrency firms seeking bank charters. The Fed, OCC, and FDIC have identified areas where (traditional or crypto) 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

bank-call-off-long-delayed-merger. In 2022, State Street 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.

[88] For background, see CRS In Focus IF12405, *Introduction to Cryptocurrency*, by Paul Tierno.

crypto[89] on their own balance sheets.[90] In addition, banks can offer traditional banking services, such as loans or deposit accounts, to cryptocurrency firms.

Extreme volatility 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. Broadly, bank regulators' enthusiasm for potential bank participation in crypto markets has waxed and waned in recent years in response to changes in agency leadership and crypto market events. Following the failure of one of the largest crypto exchanges (FTX) in 2022[91] and the liquidation of two banks (Silvergate and Signature) with crypto exposure in 2023, the bank regulators' approach to crypto arguably shifted from ambivalence to greater caution and skepticism.

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

For more information, see CRS In Focus IF12320, *Crypto and Banking: Policy Issues*, by Marc Labonte, Andrew P. Scott, and Paul Tierno; CRS Insight IN12148, *The Role of Cryptocurrency in the Failures of Silvergate, Silicon Valley, and Signature Banks*, by Paul Tierno.

Traditional Bank Participation in Crypto

Banks are closely regulated for safety and soundness, consumer protection, and AML, among other things, and bank regulators have broad authority to block or restrict any bank activity that is not consistent with these principles. To date, the bank regulators have not promulgated any rules through the notice-and-comment process to regulate crypto, relying instead on the existing regulatory framework. To interpret how crypto fits in the existing framework, the Fed, sometimes jointly with the other banking agencies, issued a series of guidance documents in 2022 and 2023. The guidance lays out that banks cannot engage in crypto activities until they have been explicitly approved by their regulators.[92] The regulators have primarily taken a safety and soundness approach to banks' participation in crypto markets. Thus, instead of blanket approval or disapproval of specific crypto-related activities, regulators have required banks to demonstrate on a case-by-case basis that they can engage in given activities in a safe and sound manner. In addition, banks must demonstrate that the activity is legally permissible and that they are complying with all applicable laws and regulations.[93] Generally, activities are permissible only if they are part of or incidental to the business of banking as laid out by statute, regulation, and precedent.[94]

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[89] 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. Typically, U.S. bank regulators have implemented Basel standards through the domestic rulemaking process. BCBS, *Second Consultation on the Prudential Treatment of Cryptoasset Exposures*, June 2022, https://www.bis.org/bcbs/publ/d533.pdf.

[90] 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.

[91] See CRS Insight IN12047, *What Happened at FTX and What Does It Mean for Crypto?*, by Paul Tierno.

[92] 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.

[93] Board of Governors of the Federal Reserve System, FDIC, and OCC, "Joint Statement on Crypto-Asset Risks to Banking Organizations," January 3, 2023, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230103a1.pdf.

[94] 12 C.F.R. 7.1000-7.1030.

The bank regulators identified a number of risks widely associated with crypto that they believe cannot easily be mitigated, including the risk of fraud, legal uncertainty, contagion, price volatility, unfair and deceptive practices, and inaccurate and misleading representations. These create high hurdles for regulatory approval, placing the "burden of proof" on banks to demonstrate that these concerns have been adequately addressed. More specifically, they "believe that issuing or holding as principal crypto-assets that are issued, stored, or transferred on an open, public, and/or decentralized network, or similar system is highly likely to be inconsistent with safe and sound banking practices."[95]

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 regulate risk in the underlying crypto markets, as is true for any industry. This inherently limits the extent that those risks can be effectively managed by banks. Former Fed Vice Chair Lael 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."[96]

A blanket ban on providing traditional banking services to crypto firms would have been particularly problematic because of controversies over whether banks can deny services to specific industries.[97] In this case, the regulators have repeatedly emphasized that banks "are neither prohibited nor discouraged from providing banking services to customers of any specific class or type, as permitted by law or regulation." However, the regulators also emphasized they "have significant safety and soundness concerns with business models that are concentrated in crypto-asset-related activities or have concentrated exposures to the crypto-asset sector."[98] They also identified traditional deposits by crypto firms that depend on customer activity or deposits that are stablecoin reserves as posing "heightened liquidity risks to banking organizations due to the unpredictability of the scale and timing of deposit inflows and outflows."[99]

For banks under its jurisdiction, the Fed's approach is to defer to the OCC and FDIC where those regulators have made a determination on what activity is permissible under law and laid out limitations surrounding the activity. The Fed stated that where there is a "clear and compelling rationale" it could deviate from standards set by the OCC and FDIC and approve an activity, but it stated that to date it has not done so.[100] When the OCC or FDIC has not made a determination, a bank could not carry out an activity until the Fed had granted approval. In any case, the Fed will grant approval only when it is satisfied that the activity can be carried out in a safe and sound manner. The Fed specifically stated that it will "presumptively prohibit" banks from holding most crypto assets as principal (as opposed to holding it on behalf of a customer), as it has not found

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[95] Board of Governors of the Federal Reserve System, FDIC, and OCC, "Joint Statement on Crypto-Asset Risks to Banking Organizations."

[96] 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.

[97] See CRS Legal Sidebar LSB10571, *Office of the Comptroller of the Currency's Fair Access to Financial Services Rule*, by M. Maureen Murphy.

[98] Board of Governors of the Federal Reserve System, FDIC, and OCC, "Joint Statement on Crypto-Asset Risks to Banking Organizations."

[99] Board of Governors of the Federal Reserve System, FDIC, and OCC, "Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities," February 23, 2023, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230223a1.pdf.

[100] The Fed refers to this as a "rebuttable presumption" that an activity is not permitted if the FDIC or OCC have found it to not be permitted. Board of Governors of the Federal Reserve System, "Policy Statement on Section 9(13) of the Federal Reserve Act," 88 *Federal Register* 7848, February 7, 2023, https://www.govinfo.gov/content/pkg/FR-2023-02-07/pdf/2023-02192.pdf.

any statutory authority for banks to do so and does not believe that banks could do so in a safe and sound manner.[101] (For the Fed's view on bank participation in stablecoin markets, see the section below entitled "Payment Stablecoins.")[102]

The Fed does not keep a public record of what crypto activities it has approved or disapproved at banks under its jurisdiction, so it is hard to gauge the extent that banks are currently involved in crypto. There are examples where the Fed has acknowledged that it has approved such activities, such as crypto custody services by the Bank of New York Mellon. In that case, the Fed stated that risks are primarily being addressed through the supervisory process.[103]

In August 2023, the Fed created a Novel Activities Supervision Program as a dedicated group to supervise banks' technology-driven partnerships, crypto activities, use of distributed ledger technology, and provision of banking services to crypto and fintech firms. The group supervises banks alongside its existing supervisory team.[104]

Permissible activities for banks can be laid out explicitly in law or, when the law is silent, be determined by the bank regulators. If Congress disagrees with the regulators' approach, it could explicitly allow or prohibit crypto activities through legislation or set parameters around the activities that expand or reduce bank involvement. So long as bank regulators remain convinced that certain crypto activities are incompatible with safety and soundness and AML requirements, however, regulators may remain reluctant to allow banks to engage in crypto activities, even if Congress identified those activities as permissible.

The House Financial Services Committee on July 26, 2023, and the House Agriculture Committee on July 27, 2023, ordered to be reported H.R. 4763, which would, among other things, confirm that banks may provide custody services for crypto and other digital assets and prohibit the bank regulators from imposing capital requirements that would discourage banks from offering custody services for crypto.[105]

Policy issues going forward include the following:

- Are crypto activities inherently too risky for banks or BHCs to participate in, as evidenced by the failures of banks with crypto exposure in 2023? 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

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[101] Board of Governors of the Federal Reserve System, "Policy Statement on Section 9(13)."

[102] 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, incidental to finance, or complementary to finance. To do so, BHCs must elect to become financial holding companies and meet certain regulatory requirements. 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. Activities that are financial in nature are laid out in Title 12, Section 225.86, of the *Code of Federal Regulations*. If an activity has not already been identified as permissible, the Fed would have to approve it.

[103] Defendant Board Of Governors Of The Federal Reserve System's Response To Plaintiff's Notice And Submission Of Supplemental Authority, Custodia Bank, Inc., Plaintiff, v. Board Of Governors Of The Federal Reserve System & Federal Reserve Bank Of Kansas City, Case 1:22-cv-00125-SWS Document 99, October 19, 2022, https://assets.law360news.com/1541000/1541860/https-ecf-wyd-uscourts-gov-doc1-20712233928.pdf.

[104] Federal Reserve, "Creation of Novel Activities Supervision Program," August 8, 2023, https://www.federalreserve.gov/supervisionreg/srletters/SR2307.htm.

[105] For more information, see CRS Insight IN12223, *An Overview of H.R. 4763, Financial Innovation and Technology for the 21st Century Act*, by Paul Tierno and Eva Su.

umbrella reduce risks or legitimize an industry that is inherently harmful to consumers and the economy?

- Are bank regulators applying the same standards in their approval of crypto activities of traditional banks and crypto firms with bank charters? Are limits on traditional bank services provided to the crypto industry necessary from a safety and soundness perspective, or are they unfairly discriminating against the crypto industry? Is rulemaking needed to ensure equal treatment, or are the current rules well suited to recent developments?
- 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 Congress preempt regulatory action to ensure that banks may or may not participate in certain aspects of crypto markets?

Crypto Firms Seeking Bank Charters

Some crypto firms have received trust charters or other special purpose charters from the OCC or state bank regulators, most notably a special purpose depository institution (SPDI) charter from the state of Wyoming.[106] The OCC or state granting the charter could potentially impose limits on activities that the firm could engage in, such as deposit taking. Generally, banks that do not accept insured deposits are not subject to all of the same regulations as banks that accept deposits are and would not have a primary federal regulator unless they are federally chartered or are members of the Federal Reserve system. State-chartered institutions, including those with nontraditional charters, have the option to apply to become state member banks, in which case the Fed would become their primary federal regulator. Custodia is a Wyoming SPDI focused on crypto that applied to join the Federal Reserve system, stating in its application that it did not intend to seek federal deposit insurance. In 2023, the Fed denied Custodia's membership application. Some of the Fed's reasons for denial were specific to deficiencies it identified in Custodia's application, but some had broader implications for crypto firms becoming state member banks. In its denial, the Fed stated that Custodia had

> an unprecedented business model that presents heightened risks involving activities that no state member bank previously has been approved to conduct.… Given the speculative and volatile nature of the crypto-asset ecosystem, the Board does not believe that this business model is consistent with the purposes of the Federal Reserve Act.[107]

The denial also stated that

> the future earnings prospects of the business model that Custodia has proposed—that is, an uninsured, undiversified, crypto-asset-focused business model featuring a number of novel and untested activities posing heightened risks—is inconsistent with approval.[108]

Some crypto firms are also interested in accessing a Fed master account, which would provide direct access to the traditional payment system.[109] Along with other nontraditional applicants,

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

[107] Federal Reserve System, "Custodia Bank, Inc. Cheyenne, Wyoming, Order Denying Application for Membership," January 27, 2023, https://www.federalreserve.gov/newsevents/pressreleases/files/orders20230324a1.pdf.

[108] Ibid.

[109] See the section below entitled "Payments."

such as fintech firms, this has led to greater scrutiny on who should be granted a master account.[110] The Fed issued final guidance in August 2022 through the notice-and-comment process explaining how it would evaluate master account applications.[111] 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 federal banking agencies 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. Two applicants have had their requests for master accounts rejected since December 2022—Custodia and a fintech firm. In addition, at least five crypto firms (Bankwyse, Commercium Financial, and Kraken Financial—each of whom have Wyoming SPDI charters—Protego, and Paxos[112]) have applications currently pending.[113] Custodia has filed a lawsuit against the Fed for rejecting its master account application.[114]

Policy issues going forward include the following:

- Should crypto firms with federal or state bank charters be granted direct access to the Fed's discount window and master accounts?
- Should the Fed approve requests from state-chartered crypto firms to become members of the Federal Reserve system?

Cannabis Banking

Many states have legalized marijuana, whereas it remains a Schedule I controlled substance under federal law.[115] 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. 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 Senate Banking Committee reported the SAFER Banking Act (S. 2860) on September 28, 2023.[116] Among other things, the bill would prevent regulators from penalizing banks solely for offering banking services to

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

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

112 Bank Reg Blog, "Talking Tier 3 Master Account Requests," June 17, 2023, https://bankregblog.substack.com/p/talking-tier-3-master-account-requests.

113 CRS search of Fed master accounts database at https://www.federalreserve.gov/paymentsystems/master-account-and-services-database-access-requests.htm.

114 Kyle Campbell, "Custodia Amends Fed Lawsuit, Alleges 'Coordinated Effort' to Deny Master Account," *American Banker*, February 17, 2023, https://www.americanbanker.com/news/custodia-amends-fed-lawsuit-alleges-coordinated-effort-to-deny-master-account.

115 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.

116 In the 117th Congress, the House passed a similar bill, the SAFE Banking Act (H.R. 1996).

cannabis businesses operating in compliance with state law. It would also provide 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 require that the bank regulators clarify that offering banking services to businesses producing goods using hemp is legal under federal law. The bill would prohibit bank regulators from requesting that banks terminate customer accounts without a valid reason and solely on the basis of reputational risk.

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 banking access? 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 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 Legal Sidebar LSB11076, *Marijuana Banking: Legal Issues and the SAFE(R) Banking Acts*, by David H. Carpenter.

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.
- FedNow, a real-time settlement system that allows banks to offer real-time retail payments, which launched in July 2023.[117]

The Fed offers intraday credit to participants in its payment services to help them avoid settlement failure. 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.[118] 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

[117] For more information, see CRS Insight IN12207, *Federal Reserve Launches FedNow*, by Marc Labonte.

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

payment system participants that are not banks are not all under its jurisdiction.[119] 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.[120] 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.

As noted above, access to Fed master accounts has become controversial in recent years, as crypto and fintech firms with bank charters have applied. In the 117th Congress, Title LVIII, Subtitle F, of the National Defense and Authorization Act for FY2023 (P.L. 117-263) required the Fed to publicly release a quarterly list of institutions (excluding official institutions) that have requested, been rejected for, or been granted master accounts. The Fed maintains a public database to comply with this law.[121]

Current payment systems issues of interest to Congress are discussed below.

Payment Stablecoins

Stablecoins are cryptocurrencies that are tied in value to some reference currency.[122] 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 that are used—or, in some cases, have the potential to be used—to make retail payments are referred to as payment stablecoins.

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. Potential justifications include consumer protection, promoting innovation in payments, and because run risk potentially poses systemic risk if stablecoins grow or become interconnected with the traditional financial system, as FSOC has argued.[123]

In 2023, the Fed issued guidance that banks it regulates are permitted to issue dollar-denominated tokens, such as payment stablecoins, if they receive approval from the Fed by demonstrating that they can do so in a safe and sound manner. However, the Fed stated that it "generally believes that issuing tokens on open, public, and/or decentralized networks, or similar systems is highly likely to be inconsistent with safe and sound banking practices" because of operational,

[119] 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.

[120] 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.

[121] The database is available at https://www.federalreserve.gov/paymentsystems/master-account-and-services-database-about.htm.

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

[123] 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.

cybersecurity, run, and illicit finance risks.[124] Arguably, the Fed has created an approval process that rules out any stablecoin operating on an open decentralized network from ever being approved. Bank regulators also identified deposits that are stablecoin reserves as posing "heightened liquidity risks to banking organizations due to the unpredictability of the scale and timing of deposit inflows and outflows."[125]

Some Members of Congress from both parties on both the House Financial Services Committee and the Senate Banking Committee, as well as the Treasury and banking regulators,[126] have called for legislation to regulate payment stablecoins. However, there is disagreement on how to regulate them and what types of firms should be allowed to issue them. The House Financial Services Committee ordered H.R. 4766, sponsored by Chair Patrick McHenry, as amended in the nature of a substitute to be reported on July 27, 2023. It would provide a regulatory framework specific to payment stablecoins. The bill would allow banks to issue stablecoins through subsidiaries under the supervision of their primary regulators, including the Fed for state member banks. The bill would also give the Fed rulemaking authority over nonbanks that issue stablecoins.

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?
- Should banks, nonbanks, or both be permitted to issue stablecoins, given financial stability concerns? If so, should bank issuance be limited to payment stablecoins? Is legislation required in practice to allow banks to issue 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?

For more information, see CRS Insight IN12249, *An Overview of H.R. 4766, Clarity for Payment Stablecoins Act*, by Paul Tierno and Andrew P. Scott; and CRS In Focus IF12450, *Stablecoin Policy Issues for the 118th Congress*, by Paul Tierno.

Central Bank Digital Currency[127]

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. According to a survey from the Bank for International Settlements, "Nine out of 10 central banks are exploring

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[124] Board of Governors of the Federal Reserve System, "Policy Statement on Section 9(13)." In August 2023, the Fed laid out an approval process for banks requesting permission to issue dollar tokens, noting the various risks that would need to be addressed for approval to be granted. Federal Reserve, "Supervisory Nonobjection Process for State Member Banks Seeking to Engage in Certain Activities Involving Dollar Tokens," August 8, 2023, https://www.federalreserve.gov/supervisionreg/srletters/SR2308.htm.

[125] Board of Governors of the Federal Reserve System, FDIC, and OCC, "Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities."

[126] 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.

[127] This section draws from other CRS products coauthored with Rebecca Nelson.

central bank digital currencies (CBDCs), and more than half are now developing them or running concrete experiments."[128] 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 Eastern Caribbean is piloting its digital currency (DCash) in four countries; and the European Central Bank, Bank of Japan, and Swiss National Bank have all engaged in pilot testing. 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 predominant "reserve currency" status in international trade and payments.[129]

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, more reliable, 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 now that the Fed has introduced FedNow, its real-time settlement system. 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 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,[130] 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 the expense of some 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."[131] Likewise, a 2022 Treasury report in response to an executive

[128] 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.

[129] 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.

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

[131] 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.

order[132] did not take a position on whether the United States should pursue a CBDC.[133] 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.

Congress has considered CBDC legislation in the 118th Congress, some of which have seen legislative action. On September 20, 2023, the House Financial Services Committee ordered H.R. 5403 as amended in the nature of a substitute to be reported. H.R. 5403 would prohibit the Fed from issuing a CBDC without congressional authorization. Two other bills related to CBDCs were on the agenda for that markup but not considered. H.R. 3402 would also prohibit the Fed from issuing a CBDC without congressional authorization. H.R. 3712 would prohibit the Fed from initiating any pilot programs related to CBDCs.

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 a CBDC provide now that FedNow is operational?
- Could international coordination on CBDCs improve the efficiency of cross-border transactions?
- 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 In Focus IF11471, *Central Bank Digital Currencies*, by Marc Labonte and Rebecca M. Nelson.

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[132] 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.

[133] 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.

Lender of Last Resort

The Fed was originally created primarily to act as a lender of last resort. But over time, the Fed's other responsibilities grew out of this role, and the lender of last resort role became secondary. 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 and the COVID-19 pandemic.

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.[134] 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.[135] 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.[136] The Dodd-Frank Act also created new disclosure requirements for 13(3) lending—for details and current legislation to amend those requirements, see the section below entitled "Fed Independence and Congressional Oversight."

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.[137])

[134] The Fed's lending facility is called the discount window because in the Fed's early years, a bank that wanted a loan would take its securities to a window at its Federal Reserve bank to be discounted.

[135] 12 U.S.C. §343. See CRS Report R44185, *Federal Reserve: Emergency Lending*, by Marc Labonte.

[136] 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.

[137] The Fed and other bank regulators also provided regulatory relief to banks during the COVID-19 pandemic to (continued...)

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 defaulted or securities fell in value. Assistance outstanding under these facilities peaked at nearly $200 billion in April 2020, then hovered around $100 billion for the rest of the year, and some assistance still remains outstanding. Treasury pledged $215 billion (of which $195 billion were CARES Act funds) to backstop potential losses on these facilities.[138] In retrospect, all of the facilities that are wound down made a "profit" (i.e., had positive net income over their lifetimes) for the taxpayer, and those still holding assets and liabilities are currently projected to make a profit, except possibly the MSLP.[139]

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.

For more information, see CRS Report R46411, *The Federal Reserve's Response to COVID-19: Policy Issues*, by Marc Labonte.

Discount Window Lending to Failed Banks in 2023

Discount window lending during the spring of 2023 suddenly spiked and reached an all-time high (in nominal dollars) of $295.7 billion on March 15, 2023. These loans were made almost entirely to the three large banks that failed (see the section above entitled "Silicon Valley Bank (SVB) Failure.") Around the time of their failures, discount window lending to SVB peaked at $127

support lending. For more information, see CRS Report R46422, *COVID-19 and the Banking Industry: Risks and Policy Responses*, coordinated by David W. Perkins.

[138] 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.

[139] 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 has realized some losses related to loan defaults to date and has set aside loan loss reserves for potential future losses. However, income earned to date has exceeded actual losses and current loss reserves. If the programs ultimately suffered losses, they would be absorbed by the Treasury's equity investment in the program using CARES Act funding.

billion, Signature at $54 billion, and First Republic at $109 billion.[140] (First Republic also borrowed from the Fed's Bank Term Funding Program, discussed below.) When the banks failed, outstanding discount window loans were assumed by the bridge banks created by the FDIC to resolve the failed banks, and the SVB and Signature bridge banks received new discount window loans (included in the totals cited here). The FDIC, rather than the banks that assumed the failed banks' assets, assumed responsibility for repaying the loans.[141] It is unclear why the FDIC borrowed from the Fed's discount window instead of using its line of credit with the Treasury, but FDIC Chair Gruenberg testified that the debt limit, which was binding at the time, was not the reason.[142] Collateral and FDIC guarantees meant that the Fed faced no risk of losses on these loans. However, they may have increased losses to the FDIC if they delayed the banks' failure and the banks' net worth decreased during that time. All remaining loan balances were repaid (with interest) at the end of November 2023.

Eligibility for primary credit at the discount window is based on being well capitalized under the prompt corrective action guidelines or being well rated for supervisory purposes.[143] The failed banks were still considered well capitalized at the time of their failures. If a bank is not well capitalized or well rated, it can borrow under the secondary credit program only at higher interest rates and under more strict limitations.

Discount window loans can be made quickly if banks have prepared ahead of time, including pre-pledging collateral. Signature and SVB both struggled to successfully borrow from the discount window when they experienced liquidity crises because they were not sufficiently prepared.[144] In July 2023, the depository regulators issued updated guidance encouraging depositories to be prepared to use the discount window when needed.[145] Acting OCC Comptroller Michael Hsu proposed a new regulatory requirement to pledge enough collateral at the discount window to meet potential deposit outflows.[146]

Bank Term Funding Program[147]

In March 2023, the Fed announced the creation of the Bank Term Funding Program (BTFP)—on the same day the FDIC, Fed, and Treasury announced that all uninsured deposits at SVB and Signature would be guaranteed. According to the Fed, "this action will bolster the capacity of the banking system to safeguard deposits and ensure the ongoing provision of money and credit to

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140 Questions for the record by FDIC Chair Martin Gruenberg in U.S. Congress, House Committee on Financial Services, *The Federal Regulators' Response to Recent Bank Failures*, 118th Cong., 1st sess., March 29, 2023, p. 189, https://www.govinfo.gov/content/pkg/CHRG-118hhrg52390/pdf/CHRG-118hhrg52390.pdf; FDIC Office of Inspector General, *Material Loss Review of First Republic Bank*, November 28, 2023, p. 24, https://www.fdicoig.gov/sites/default/files/reports/2023-12/EVAL-24-03.pdf.

141 Federal Reserve, *Additional Information on Other Credit Extensions*, June 9, 2023, https://www.federalreserve.gov/monetarypolicy/additional-information-on-other-credit-extensions.htm.

142 Gruenberg, p. 188.

143 12 C.F.R. 201.2.

144 Federal Reserve, *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank*, April 2023, p. 59, https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf; FDIC, *FDIC's Supervision of Signature Bank*, April 2023, p. 15, https://www.fdic.gov/news/press-releases/2023/pr23033a.pdf.

145 Federal Reserve, FDIC, National Credit Union Administration, OCC, "Agencies Update Guidance On Liquidity Risks and Contingency Planning," joint press release, July 28, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230728a.htm.

146 See OCC, "Acting Comptroller Discusses Bank Liquidity Risk," press release, January 18, 2024, https://occ.gov/news-issuances/news-releases/2024/nr-occ-2024-4.html.

147 This section draws from other CRS products coauthored with Lida Weinstock.

the economy."[148] In the face of significant deposit withdrawals at some banks in the spring of 2023, the program provided an alternative for accessing liquidity to selling off securities—potentially at a loss—or borrowing from the private sector or the Fed's discount window.

In some ways, the emergency BTFP functions similarly to the discount window—both are places banks and other insured depository institutions can pledge collateral in return for cash, thereby increasing their liquidity. Banks that are undercapitalized cannot borrow from the discount window's primary credit program or the BTFP. When the BTFP was created, the Fed adjusted margin requirements for the discount window so that banks can borrow up to 100% of the collateral value for these securities from each.

However, there are a few key differences between the BTFP and the Fed's discount window (see **Table 2**). The loans are backed by a narrower set of high-quality collateral, such as U.S. Treasuries and MBS, than the discount window. The other differences make this facility more attractive than the discount window. The BTFP provides banks with loans of up to one-year maturity, whereas discount window loans have terms of up to 90 days. Most importantly, banks are allowed to pledge those securities at par (face) value instead of market value. This benefits banks, because many securities they bought when interest rates were lower have fallen in market value as interest rates have increased, making their borrowing potential higher at the BTFP compared to the discount window. As of the third quarter of 2023, banks had over $680 billion in unrealized losses on their securities holdings.[149] In that regard, the BTFP may have also helped banks avoid solvency problems, although solvency problems are avoidable only because, under the regulatory treatment, unrealized losses do not reduce most banks' capital. In addition, the BTFP's interest rate has been lower in practice than the discount window's.

Table 2. Comparison of BTFP and Discount Window Terms

Category	BTFP	Discount Window
Eligible collateral	Only collateral that is eligible for purchase by the Fed in open market operations	Wider range of securities and loans
Collateral valuation	Par value	Market value
Margin	100%	100% on collateral eligible for BTFP, but margins on other types of eligible collateral remain[a]
Term	Up to one year	Up to 90 days
Rate[b]	One-year overnight index swap rate plus 10 basis points fixed at time of advance	Rate set by Fed, typically at top of federal funds rate target range for primary credit

Source: Federal Reserve, *Bank Term Funding Program FAQs*, https://www.federalreserve.gov/monetarypolicy/files/bank-term-funding-program-faqs.pdf.

a. For margins for securities under the discount window, see https://www.frbdiscountwindow.org/Pages/Collateral/collateral_valuation.

b. For current rates, see https://www.frbdiscountwindow.org/.

[148] Federal Reserve, "Federal Reserve Board Announces It Will Make Available Additional Funding to Eligible Depository Institutions to Help Assure Banks Have the Ability to Meet the Needs of All Their Depositors," press release, March 12, 2023, https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312a.htm.

[149] FDIC, *Quarterly Banking Profile*, November 29, 2023, p. 2, https://www.fdic.gov/analysis/quarterly-banking-profile/qbp/2023sep/.

In fact, the rate has at times been lower than the interest rate the Fed pays banks on reserves held at the Fed because of the movement in market interest rates, potentially creating an arbitrage opportunity where a bank could borrow from the Fed and deposit the proceeds in its reserve account, profiting from the spread between the two rates.[150] This may help explain why loans outstanding under the BTFP have continually risen over the program's existence and stood at nearly $136 billion at the end of 2023. Unlike the discount window (outside of the loans to the failed banks), use of the BTFP has not returned to minimal levels since financial conditions have normalized, and it grew rapidly in December 2023 and January 2024, when the spread between the two rates widened.[151] On January 24, 2024, the Fed placed a new floor on the borrowing rate to eliminate this arbitrage opportunity.

The BTFP was authorized under Section 13(3) emergency authority—as opposed to the Fed's normal bank lending authority used for the discount window.[152] As required by statute, the Fed Board of Governors unanimously found "unusual and exigent circumstances" to justify its creation, and the program was approved by the Treasury Secretary. Treasury pledged $25 billion in assets from the Exchange Stabilization Fund to backstop potential future losses that the program might incur.[153] The Fed reported to Congress that it does not expect losses on the program, because the loans are backed by collateral and the loans are made with recourse (i.e., borrowers must repay beyond the collateral value).[154] By law, details about loan transactions, including the identities of participants, will be publicly disclosed one year after the program closes. The Fed has announced that the facility will expire as scheduled in March 2024.

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 and the 2023 bank failures? Are more restrictions needed to ensure that Section 13(3) programs, such as the BTFP, do not provide banks with low funding arbitrage opportunities?
- Do the benefits of emergency lending, such as quelling liquidity panics, outweigh the costs, including moral hazard? 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?

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[150] David Benoit and Eric Wallerstein, "The Fed Launched a Bank Rescue Program Last Year. Now, Banks Are Gaming It," *Wall Street Journal*, January 10, 2024, https://www.wsj.com/finance/banking/the-fed-launched-a-bank-rescue-program-last-year-now-banks-are-gaming-it-43e9cee3.

[151] Alexandra Harris, "Cheap Costs Push Use of Fed Term Funding Tool to Fresh Record," *Bloomberg Government*, January 4, 2024, https://www.bgov.com/next/news/S6RALJDWLU68.

[152] This is not the first time the Fed has created an emergency lending facility for banks. The Fed created the Term Auction Facility (TAF) in December 2007 in response to the financial crisis to auction reserves to banks. The Fed set the amount of reserves up for auction, with the rate determined at auction. The loans under this program were longer term than typical discount window or private market loans, although they were shorter than BTFP loans. Auctions through TAF exceeded loans made through the discount window, peaking at $493 billion. The final TAF auction was held in March 2010. The Fed did not use Section 13(3) to create TAF but rather used the lending authority used for the discount window (12 U.S.C. §347b). All loans made under TAF were repaid. For more information, see Federal Reserve, "Term Auction Facility (TAF)," https://www.federalreserve.gov/regreform/reform-taf.htm.

[153] For more information, see CRS In Focus IF11474, *Treasury's Exchange Stabilization Fund and COVID-19*, by Marc Labonte, Baird Webel, and Martin A. Weiss.

[154] Federal Reserve, *Report to Congress Pursuant to Section 13(3) of the Federal Reserve Act: Bank Term Funding Program*, March 16, 2023, https://www.federalreserve.gov/publications/files/13-3-report-btfp-20230316.pdf.

- Has operating emergency facilities undermined the Fed's independence or political neutrality? Are these programs better suited to Treasury administration?
- Should the Fed be the lender of last resort to banks only or to all parts of the financial system? 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 continue to be used to back Fed facilities in the future, and should its statutory authority be revised to affirm or prohibit that role?
- Should the Fed make discount window loans to provide short-term financing of FDIC resolutions, or should the FDIC use its line of credit to the Treasury to meet its liquidity needs?
- Should changes be made to discount window eligibility, as the large banks remained well capitalized by regulatory standards and were borrowing from the discount window shortly before their failures in 2023? Or was discount window lending to these banks appropriate given the liquidity runs they experienced?
- Are the terms of the BTFP—notably valuing collateral at par instead of market value—a form of regulatory forbearance that works at odds with prompt corrective action? Or is it appropriate given that all but the largest banks do not have to value most securities at market value for regulatory capital purposes? Did the terms of the BTFP improperly create arbitrage opportunities for banks?

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.[155] Economists view independence as leading to better monetary policymaking because, subject to less political pressure, the Fed can choose policies that are optimal under a longer-term horizon. 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. In addition, some critics downplay the degree of Fed oversight and disclosure that already takes place.

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 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. 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.[156] 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.

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[155] In terms of relative independence, 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.

[156] Title LVIII, Subtitle F, of the National Defense and Authorization Act for FY2023 (P.L. 117-263) required 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.

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. The Fed also voluntarily produces a semiannual report on regulation and supervision and a semiannual report on financial stability. Congress occasionally requires the Fed to produce reports on other miscellaneous topics.[157] 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. 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.[158] 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.

One notable difference between the Fed and most other government agencies is that there is no congressional oversight of the Fed's budget—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.[159] 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. In the past, the Fed has opposed proposals to remove statutory restrictions on GAO audits and require a general GAO audit on the grounds that they would reduce the Fed's independence from Congress.

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.[160] 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.

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

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

[159] 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.

[160] §§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).

The CARES Act also included testimony and reporting requirements for Fed actions during the pandemic involving CARES Act funding.[161]

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) since 1993, currently with a three-week lag, and transcripts of those deliberations with a five-year lag since 1995.[162] 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 or limit FOIA requests.[163] (Critics have called for making the Federal Reserve banks subject to FOIA as well.[164]) Some studies found the Fed to rank as one of the more transparent central banks in the world.[165]

The SVB failure led Congress to focus on congressional oversight and transparency of Fed supervision.[166] The Senate Banking Committee reported S. 2190 on June 22, 2023, which, among other things, would require the Fed to produce a semiannual report on regulation and supervision with similar contents to the existing regulation report plus information on its internal operations and culture for supervision. Whenever a bank with over $10 billion in assets under the Fed's jurisdiction fails, the bill would also require an inspector general review of whether Fed supervisory practices played a role in the failure of the bank.[167]

The House Financial Services Committee ordered H.R. 3556 to be reported in the nature of a substitute on May 24, 2023, which, among other things, would:

- accelerate the public disclosure of open market operations and discount window lending records from two years to one year;
- expand the scope of information that Congress could request from the Fed about its 13(3) emergency facilities, provide access to nonpublic emergency lending records (including personal information) to the committees of jurisdiction upon request, and remove restrictions on GAO providing transaction records from Fed

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161 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.

162 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.

163 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.

164 In December 2023, the Federal Reserve banks adopted a uniform policy on records disclosure. The policy is available at https://www.newyorkfed.org/medialibrary/media/newsevents/statements/2023/transparency-accountability-policy.

165 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*, vol. 24, no. 4 (December 2008), 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 in 1998 because the Fed discontinued its release of money growth targets between those dates.

166 See the section above entitled "Silicon Valley Bank (SVB) Failure."

167 Currently under Title 12, Section 1831o(k), of the *U.S. Code*, any time a bank failure causes a material loss to the FDIC, the inspector general must review the bank regulator's supervision to ascertain the reason for the failure.

lending facilities, including information on the identities of borrowers, to Congress; and

- require the vice chair for supervision to submit a semiannual report to Congress along with testimony that provides data on supervisory ratings, material supervisory determinations, and informal and formal enforcement actions, along with a confidential report identifying banks with poor supervisory ratings and active informal and formal enforcement actions.

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? Would greater congressional access to private lending records improve oversight or risk undermining a bank's financial condition through improper public release?
- 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?
- Should Congress be kept better informed about banks' supervisory problems, or would this risk undermining a bank's financial condition through improper public release? Does Congress have sufficient aggregate information about bank supervision to support its oversight role?
- Does the 2021 trading scandal involving Federal Reserve bank presidents indicate that more congressional oversight is needed?[168] Does the Fed's 2022 rules banning trading by leadership obviate the need for legislation?[169]

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

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

[168] 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.

[169] 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. The policy was extended to additional employees in 2024. See FOMC, "Federal Open Market Committee Announces Updates That Further Enhance Its Policy on Investment and Trading," press release, January 31, 2024, https://www.federalreserve.gov/newsevents/pressreleases/monetary20240131c.htm.

Reserve System and other federal financial regulators, and those offices are required to produce annual reports to Congress.

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 the following:

- 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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Disclaimer