Financial Services Management

Federal Reserve Bank Dividends

Cite
H.R. 5027

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Impact Assessment

- Approximately $30 billion in Reserve Bank capital would be returned to member banks.
- The Reserve Bank System would have a smaller capital base, beginning the process of *de facto* nationalizing its operations.
- Arguments germane to this bill will drive debate over IOER recapture later this year.

Overview

Following statutory action last year to reduce the dividends paid to member banks by Federal Reserve Banks,[1] a senior House Republican has introduced legislation to reduce the amount of capital member banks must hold in the Federal Reserve to offset the cost of last year's dividend reduction.

Impact

Although Congress long ago opened the Federal Reserve's services to banks regardless of their membership status, membership affords unique privileges in terms of participating in and to some degree governing Reserve Bank operations. As a result, member banks have long been reconciled to holding stock in the System, a comfort level significantly bolstered by the six percent dividends paid on stock even though interest rates in recent years have been well below this level. Reflecting this, Congress as noted voted last

[1] See **FEDERALRESERVE25**, *Financial Services Management*, August 3, 2015.

year to restrict FRB dividends, especially for the largest banks, making Reserve Bank capital stock now an asset that yields returns closer to market norms. Some banks are thus pushing to have their Reserve Bank capital returned to them, although others continue to support the current Reserve Bank membership construct.

Congress last year also decided to reduce the cost to banks of reducing dividend payments by limiting the Federal Reserve capital surplus account to $10 billion and transferring the excess ($19.3 billion) to the Treasury. This bill builds on that take-away by increasing the amount of funds stripped from the Reserve Banks, giving them this time to member banks and not to the Treasury. It does not, however, take away all of the capital stock banks now hold, leaving the System with approximately $5 billion in paid-in capital and $10 billion in the capital surplus account.

In the near term, the Federal Reserve System is subject to little, if any risk with a small capital cushion because its very large asset holdings now provide a multi-billion dollar surplus paid to the Treasury each year that could be reduced and deployed to protect the System if needed. However, the FRB hopes to reduce its balance sheet back to the very small one it held prior to quantitative easing, at which point the risk to the System would be considerably greater. At any such point, Congress might need to appropriate money quickly to support the Federal Reserve or a broader systemic crisis might ensue.

On a more theoretical level, any end to member-bank capital holdings in Reserve Banks fundamentally alters the structure of the Federal Reserve. Although even without capital requirements the Banks would still have members, any lack of direct investment by these members makes membership largely symbolic. In the near term, there might be a rush of remaining non-members to join the System to gain the privilege of attending Reserve Bank events and voting for Bank officials, but the fundamental public-private construct established for the Federal Reserve in 1913 would be redesigned. This could lead to still broader calls to convert the Federal Reserve into the type of fully-governmental central bank common in most nations, subjecting it also to the very significant policy and political demands initially sketched out in legislation passed earlier this year in the House.[2] The FRB is thus certain to oppose this further taking of the assets housed by banks in the Reserve System.

Supporters of this legislation counter that the FRB no longer needs its traditional capital construct. The $30 billion that could be transferred to banks would, they argue, also support the FRB's macroeconomic goals by encouraging bank lending and thus supporting the recovery. Advocates also believe that the law cutting member bank dividends from the Reserve Banks was a "bank tax" because the funds were used to support a particular funding objective: highway infrastructure.

Although nothing in the legislation or debate to date addresses the question of Congressional action also to take the interest on excess reserves

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2 See **FEDERALRESERVE26**, *Financial Services Management*, August 12, 2015.

(IOER) now paid by the FRB to banks, any effort to do so would encounter similar objections because these funds could also be said to be a tax on banks designed to fund projects otherwise supported by general revenue. Those seeking an IOER capture have argued, however, that IOER is a "subsidy" much as some suggested when the dividend payments were cut in 2015 with regard to these transfers from the FRB to member banks.[3]

What's Next

Rep. Neugebauer (R-TX) introduced H.R. 5027 along with Rep. Pete Sessions (R-TX) on April 21. Hearings have not yet been held on it, although these may be scheduled later this spring. Even if the measure advances in the House Financial Services Committee or on the House floor, its chances of enactment as a freestanding measure or in concert with broader FRB reform[4] are uncertain through regular order. The measure stands a better chance of inclusion in the year-end spending bills, although its significant cost would need to be addressed for this to happen, posing a major challenge to final passage in both the House and Senate due to broader fiscal-policy pressures.

Analysis

The legislation alters the relationship between paid-in and callable stock for banks with over $10 billion in assets to return current paid-in stock, giving smaller banks the option to elect this treatment. Member banks with over $10 billion in assets and those electing this treatment would get 2.5 percent of their paid-in and surplus.

The changes would be effective upon enactment and smaller banks could make this decision only once and within a year of becoming FRB members or after enactment. The Federal Reserve Board could only call upon paid-in stock to support a Reserve Bank if the Bank's surplus account is exhausted. Amounts in the surplus fund over $10 billion would be returned to member banks.

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[3] See Client Report **IOER**, September 24, 2015.

[4] See Client Reports in the **FEDERALRESERVE** series.

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