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Federal Reserve Dividend Reduction Deserves Thorough Debate

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In July, the U.S. Senate introduced a plan to offset new highway spending by reducing the dividend that the Federal Reserve pays to member banks. While it is still unclear exactly where this idea originated, an anonymous Democratic staffer recently referred to the dividend as "an unnecessary and wasteful subsidy."[1] It now appears that the dividend reduction will go forward even if it offsets outlays other than highway spending.

Reducing the dividend will alter a 100-year relationship between the Fed and member banks. At the very least, changing this policy deserves careful consideration in Congress. Without an open debate over the costs and benefits of Federal Reserve System membership, removing this dividend amounts to nothing more than a short-sighted move to increase federal revenues through yet another source.

What Is the Fed Dividend?

A condition of joining the Federal Reserve System has always been that banks must buy into the stock of their district Fed bank. Specifically, banks have to buy stock equivalent to 6 percent of their total paid-up capital stock and surplus. Half is paid up front; the remainder is held as a cash reserve. Owning these shares is more like a capital requirement than owning shares of stock in a private company, though, because the shares cannot be sold, traded, or used as collateral for a loan.[2] Because this amount can no longer be used for any other purpose, the Fed pays the banks a 6 percent dividend every year. At the Fed's founding in 1913, this dividend likely served as an important incentive to join the Federal Reserve System.[3]

Critics argue that the 6 percent rate is "overly generous,"[4] and one plan would cut the dividend to 1.5 percent for banks with more than $1 billion in assets.[5] While it is easy to criticize this dividend as a subsidy, it appears so only because interest rates on other risk-free assets are currently so low. The existing disparity in rates might, at most, suggest that the dividend should be tied to a market rate. Furthermore, while belonging to the Federal Reserve System may provide benefits that make the 6 percent dividend unnecessary, the fundamental relationship between member banks and the Fed has changed dramatically since 1913.

Membership and the Monetary Control Act of 1980

The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 essentially overrode a bank's choice to be a member of the Federal Reserve System because it gave the Fed jurisdiction over *all* depository institutions' reserves.[6] In other words, regardless of whether a bank chose to be a member of the Federal Reserve System, it was required to hold its reserves in an account at its Fed District Bank, subject to the Fed's rules. While the question of membership is largely ignored now, the Fed was *losing* member banks for more than two decades leading up to the passage of the DIDMCA.

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Between 1970 and 1978 alone, roughly 300 banks left the Fed system, and the ratio of members' deposits to total bank deposits fell from more than 80 percent to 72 percent.[7] A main reason for this loss of membership was that (inflation-driven) high nominal interest rates drastically increased members' cost of holding the zero-return reserve accounts that the Fed required. Additionally, as rates rose, nonbank financial institutions created new financial products that were similar to banks' demand deposits, but with the added benefit of paying market interest rates.[8] Many bank customers moved their funds out of banks to earn a higher return, thus further contributing to the decline in Fed member banks.[9]

Several Fed officials, including Chairman Paul Volcker, testified to Congress that the loss of member banks would result in the Fed losing control over the banking system.[10] Their main argument was that control over the reserve balances was necessary to conduct monetary policy. However, the Fed is still able to conduct monetary policy without these balances. The Fed has control over the monetary base—currency plus banks' reserves—regardless of whether the accounts are held at the Fed District Banks. Strictly speaking, even if all formal reserve requirements were eliminated, banks would still need to hold some level of cash reserves to accommodate their customers (including other banks).

Regardless of the amount of these reserves, or where the funds are held, the Fed would still have the ability to precisely control the monetary base. All Fed open-market purchases, for example, either increase the amount of reserves or of U.S. currency in circulation.[11] The same arguments apply to the Fed's discount window and emergency lending programs. That is, any discount window or emergency loans would also add to the monetary base, regardless of whether a bank is a member of the Fed or where the reserves are

1. John Heltman, "Uphill Battle Looms as Banks Look to Forestall Fed's Dividend Cut," *American Banker*, September 1, 2015, http://www.americanbanker.com/news/law-regulation/uphill-battle-looms-as-banks-look-to-forestall-feds-dividend-cut-1076444-1.html?pg=2 (accessed October 22, 2015).
2. Board of Governors of the Federal Reserve System, "Current FAQS: Who Owns the Federal Reserve?" http://www.federalreserve.gov/faqs/about_14986.htm (accessed October 22, 2015).
3. Nationally chartered banks had to join the Federal Reserve System, but state-charted banks were not required to join.
4. Joseph Lawler, "Highway Bill Would Cut Dividends Paid by Fed to Banks," *Washington Examiner*, July 21, 2015, http://www.washingtonexaminer.com/highway-bill-would-cut-dividends-paid-by-fed-to-banks/article/2568702 (accessed October 19, 2015).
5. The proposal referenced here would leave the dividend at 6 percent for smaller banks. See Kathleen Miller, Jeff Plungis, and Richard Rubin, "Senate Highway Deal Relies on Reduced Fed Payments to Banks," Bloomberg, July 21, 2015, http://www.bloomberg.com/politics/articles/2015-07-21/highway-agreement-provides-three-years-of-funds-mcconnell-says (accessed October 19, 2015).
6. Formally, the act gave the Fed jurisdiction over all depository institutions eligible for FDIC deposit insurance. 12 U.S. Code § 461(b)(1)(A).
7. Richard Timberlake, "Legislative Construction of the Monetary Control Act of 1980," *American Economic Review*, Vol. 75, No. 2 (1985), Papers and Proceedings of the Ninety-Seventh Annual Meeting of the American Economic Association, pp. 97–102, http://www.jstor.org/stable/1805578?seq=1#page_scan_tab_contents (accessed October 20, 2015).
8. The Glass–Steagall Act prohibited banks from paying interest on demand deposits because paying interest on these accounts was thought to increase banks' incentives to take risks as they competed for deposits. The DIDMCA relaxed many of these interest rate restrictions. See Robert Craig West, "The Depository Institutions Deregulation Act of 1980: A Historical Perspective," Federal Reserve Bank of Kansas City *Economic Review* (February 1982), https://www.kansascityfed.org/PUBLICAT/ECONREV/econrevarchive/1982/1q82west.pdf (accessed October 20, 2015).
9. The DIDMCA is also a classic case of both regulatory failure and capture. Depression-era legislation, ostensibly aimed at increasing financial-system safety, created several types of financial entities, each with distinctly defined allowable activities. Eventually, technological and economic changes made these activity silos untenable, and the DIDMCA represents a decades-long culmination of negotiations between (mainly) savings and loans associations, banks, and Congress. Ibid., and Anatoli Kuprianov, "The Monetary Control Act and the Role of the Federal Reserve in the Interbank Clearing Market," Federal Reserve Bank of Richmond *Economic Review* (July/August 1985), https://www.richmondfed.org/~/media/richmondfedorg/publications/research/economic_review/1985/pdf/er710403.pdf (accessed October 20, 2015).
10. Timberlake, "Legislative Construction of the Monetary Control Act of 1980."
11. For a full explanation of how the Fed exercises precise control over the monetary base, see Peter N. Ireland, "Lecture Notes on Money, Banking, and Financial Markets: Chapter 15c: The Fed's Control of the Monetary Base," http://irelandp.com/ec261/chapter15c.pdf (accessed October 20, 2015).

held. As long as it maintains monopoly control over U.S. currency, the Fed enjoys the same ability to conduct monetary policy regardless of whether banks are members or where they hold their reserves.[12]

Conclusion

Congress appears poised to offset new federal spending—possibly on highway projects—by reducing the 6 percent dividend that the Federal Reserve pays to member banks. This plan deserves careful scrutiny by Congress because changing the payment will alter a 100-year relationship between the Fed and member banks. Rather than changing this relationship simply for the sake of finding a new source of tax revenue, policymakers should take a comprehensive look at the consequences.

Perhaps it is time to remove the controls the DIDMCA gave to the Fed and force the central bank to compete with private markets. If the Fed can compete with private markets and still provide economic benefits, there is no reason why membership in the Federal Reserve System could not be fully optional. Without a full debate over the costs and benefits of Federal Reserve System membership, reducing this dividend amounts to nothing more than a shortsighted policy aimed at increasing federal spending.

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12. Even the federal funds market could be conducted outside the Fed's control because it consists merely of private banks lending excess reserves to each other.