

**FED OVERSIGHT: LACK OF TRANSPARENCY
AND ACCOUNTABILITY**

HEARING
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS
OF THE
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
ONE HUNDRED FOURTEENTH CONGRESS
FIRST SESSION

—————
JULY 14, 2015
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Printed for the use of the Committee on Financial Services

Serial No. 114-41



U.S. GOVERNMENT PUBLISHING OFFICE

97-153 PDF

WASHINGTON : 2016

For sale by the Superintendent of Documents, U.S. Government Publishing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
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FED OVERSIGHT: LACK OF TRANSPARENCY AND ACCOUNTABILITY

Tuesday, July 14, 2015

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:03 a.m., in room 2128, Rayburn House Office Building, Hon. Sean P. Duffy [chairman of the subcommittee] presiding.

Members present: Representatives Duffy, Fitzpatrick, Hurt, Fincher, Mulvaney, Hultgren, Tipton, Poliquin, Hill; Green, Cleaver, Beatty, Heck, Sinema, and Vargas.

Ex officio present: Representative Hensarling.

Also present: Representative Love.

Chairman DUFFY. The Oversight and Investigations Subcommittee will come to order. The title of today's subcommittee hearing is, "Fed Oversight: Lack of Transparency and Accountability."

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

Also, without objection, members of the full Financial Services Committee who are not members of this subcommittee may participate in today's hearing for the purposes of making an opening statement and questioning witnesses.

The Chair now recognizes himself for 3 minutes for an opening statement.

Since its creation over 100 years ago, the scope and authority of the Federal Reserve has grown exponentially. Following the 2008 financial crisis, the Dodd-Frank Act dramatically expanded the Fed's reach into the economy. Dodd-Frank granted the Fed the authority to set new capital liquidity standards, conduct stress tests, and regulate designated systemically important foreign and domestic firms that pose a threat to U.S. financial stability. These designations are determined by the Financial Stability Oversight Council, or FSOC, on which the Fed Chair sits.

While these new powers alone are a significant increase in the Fed's purview, the Fed also serves as a primary U.S. representative on the Financial Stability Board, the Basel Committee on Banking Supervision, and the International Association of Insurance Supervisors. Some market participants have expressed concern that the Fed may be showing deference to international regulatory preference rather than properly representing American interests.

For this reason and others, I introduced H.R. 2141, the International Insurance Standards Transparency and Policyholder Protection Act of 2015, and we are looking for cosponsors if any Dems want to join, Mr. Green. This bill will establish a much-needed framework for congressional oversight and stakeholder input while the Fed and others engage in international regulatory negotiations.

While the Fed's purview and power continues to grow, opacity reigns supreme within its walls. It is a fraternity where silence is golden. And no one, not even Congress, is allowed to ask questions. This is true not only of how it conducts monetary policy, but also of its internal processes.

The Fed's clamor for independence is the underpinning for its argument for circumventing any congressional accountability. Markets are left in the dark as much as Congress—unless, that is, you are one of the lucky, well-capitalized or well-connected firms that can afford non-public information from the black box that is the Fed.

This committee worked tirelessly to investigate a 2012 leak of confidential FOMC information by one such Fed insider. That information was disseminated by Medley Global Advisors to their clients, which include some of the world's top hedge funds, institutional investors, and asset managers. And yet, 3 years later, following 3 internal investigations by the Fed's own General Counsel and the IG, and countless letters from Congress, we still don't have any answers.

While we will hear tomorrow from Chair Yellen on this and other matters, we are looking forward to hearing from our panel of distinguished witnesses today on this problematic epidemic culture of opacity at the Fed.

With that, I yield 5 minutes to the ranking member of the subcommittee, Mr. Green from Texas.

Mr. GREEN. Thank you, Mr. Chairman. I thank the witnesses for appearing as well. And I am honored to have an opportunity to hopefully ask some questions that will give us all some additional insight.

Having perused the legislation and perused materials associated with this hearing, I have come to the conclusion that this hearing is really less about the auditing of the operations of the Fed and more about monitoring the deliberations of the Fed, because the Fed is currently audited. And I will introduce information into the record to show that the operations of the Fed are audited. There is no question that the Fed is audited. The question is, should their deliberations be monitored?

Having been a part of the judiciary for a number of years, I have come to appreciate deliberations that are held with a degree of privacy. When jurors deliberate, we don't allow the cameras in the room, we don't allow parties who are not associated with the jury to be in that room. Deliberations are important. You can get candid conversation, candid commentary when you don't have a third party in the room. Deliberations are important. We go into executive sessions to have deliberations so that we can speak candidly about issues. This is really about the deliberations of the Fed.

It is also more about the superintendency of the Fed than the transparency of the Fed, the superintendency in the sense that

there seems to be a desire to manage what the Fed does. We have oversight. We are not overseers of the Fed. And we should exercise our oversight authority. I fully support oversight of the Fed. But I don't think we want Congress to oversee the Fed. I think it would be a mistake of the highest magnitude to allow what we do here to infect the Fed.

We can barely make decisions. There is great stagnation. And there is a lot of politicization of what we do. Do we really want to politicize the Fed by injecting the decisions of Congress into their deliberations?

I think also that as we go through this, it is going to be important for us to recognize that Congress has put the Fed in the position that it is in. The Fed has served us well. And at some point, the independence yielding to the interference can become outright meddling. Do we want to meddle in the deliberations of the Fed? I think not.

Now, with reference to the leaks, the Department of Justice is investigating, and the Department of Justice has the tools to perform a proper investigation. The Department of Justice has indicated a desire to complete this investigation. I support a thorough investigation of these leaks, but I don't want this investigation done by Congress to the extent that we encroach upon what the DOJ is doing and to the extent that we may, in some way, create a climate such that the DOJ won't be able to perform its duties effectively. The DOJ has indicated that it would be prudent to withhold certain testimony until it has had an opportunity to complete its investigation.

I want the investigation done. I support what the DOJ is doing. But I don't want to find ourselves in the circumstance that we have with the CFPB, where Congress is taking the lead on an investigation and where we don't have all of the due process in place that should be accorded people who are being investigated.

I look forward to working with the subcommittee chairman. And if he can craft a piece of legislation that he and I can agree upon, of course I will sign on to it.

I yield back.

Chairman DUFFY. The gentleman yields back. I look forward to that.

The Chair now recognizes the the vice chairman of this subcommittee, the gentleman from Pennsylvania, Mr. Fitzpatrick, for 1 minute for an opening statement.

Mr. FITZPATRICK. Thank you, Mr. Chairman, and I also thank the witnesses for being here with us today.

Oversight of the Federal Government, whether it is agencies, individuals, or other institutions, is crucial to our system of checks and balances. The system provides an opportunity for democratically elected representatives to ensure these organizations are accountable to hard-working American families and ensure that their day-to-day operations are transparent.

Today, this subcommittee's role is to determine whether or not one such entity has grown too large or too rapidly without the expressed consent of the American people. Over the last 5 years, the Federal Reserve system of influence over the economy has grown through the development of new rules and requirements for our fi-

nancial institutions with little involvement or consultation by Congress. Furthermore, it is worth noting that while the Fed is charged with maintaining the economic health of our Nation, it has repeatedly ignored subpoenas and sidestepped congressional inquiries.

Mr. Chairman, the Fed, like all of the Federal Government, should remain open, transparent, and accountable to the American people.

I yield back. And I look forward to the witnesses' testimony.

Chairman DUFFY. The gentleman yields back.

We now recognize our witnesses for introduction. First, Dr. Mark Calabria is the director of financial regulation studies at the Cato Institute. Before joining Cato in 2009, he spent 6 years as a member of the senior professional staff of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, where I think they move just a bit slower, Dr. Calabria.

Second, Dr. Paul Kupiec is a resident scholar at the American Enterprise Institute (AEI), where he studies systemic risk in the management and regulation of banks and financial markets.

Third, we have Dr. John Taylor. He is the George P. Shultz Senior Fellow in Economics at the Hoover Institute and the Mary and Robert Raymond Professor of Economics at Stanford University. Dr. Taylor's field of expertise includes monetary policy, fiscal policy, and international economics.

And finally, we have the Honorable Alice Rivlin. She is the director of the Health Policy Center at the Brookings Institution and the Leonard D. Schaffer Chair in Health Policy. She is also a senior fellow in the Economic Studies Program at Brookings and a visiting professor at the McCourt School of Public Policy at Georgetown University.

The witnesses will now be recognized for 5 minutes to give an oral presentation of their testimony. And without objection, the witnesses' written statements will be made a part of the record. Once the witnesses have finished presenting their testimony, each member of the subcommittee will have 5 minutes within which to ask questions.

On your table there are three lights. I think all of you are very familiar with this. Green means go, yellow means you have 1 minute left, and red means your time is up. The microphones are very sensitive, so please make sure that you are speaking directly into them.

With that, Dr. Calabria, you are now recognized for 5 minutes.

**STATEMENT OF MARK A. CALABRIA, DIRECTOR, FINANCIAL
REGULATION STUDIES, CATO INSTITUTE**

Mr. CALABRIA. Thank you. Chairman Duffy, Ranking Member Green, and distinguished members of the subcommittee, thank you for the invitation to appear at today's hearing. And let me also say what an honor it is to be part of such a distinguished panel.

The word "accountability" is often used in Washington without reference to a clear meaning. So let me begin my remarks by citing Webster's, which defines accountability as an obligation or willingness to accept responsibility or to account for one's actions.

My fellow panelist, John Taylor, has detailed elsewhere how the Federal Reserve bears some responsibility for the boom and bust in the housing market that led to the financial crisis. I detail in my written remarks a number of Federal Reserve regulatory mistakes that also contributed to the crisis. Prominent among these was the Fed's support of using credit default swaps to lower bank capital, the Fed's push for adoption of Basel II, as well as the Fed's approach of off-balance-sheet risk-taking by our largest banks.

Inherent in being accountable is first coming to terms with one's mistakes. I would submit to the subcommittee that we have yet to see the Fed atone or even admit to its contributions to the crisis. Instead, what we have seen is repeated spin by the Fed with the intent to distract us.

In no way has the Fed been held accountable for its monetary regulatory mistakes. In fact, it has been rewarded by the Dodd-Frank Act with increasing powers and responsibilities. This is, of course, to say nothing of the personal rewards that its senior management has received despite their own culpability.

The logic behind Dodd-Frank would lead us to believe that the same entity which believed it was wise to allow Citibank to hold tens of billions in off-balance-sheet risk without any capital backing that risk is best qualified to now conduct similar supervision of large non-banks like MetLife.

Financial reform would have best been served, in my opinion, had prudential supervision been removed altogether from the Fed and placed at another agency, such as the FDIC. Researchers have found, for instance, that countries with central banks that are also engaged in bank regulation witness more frequent crises, as well as have greater levels of inflation. Dodd-Frank, to a small degree, held the Office of Thrift Supervision accountable for its failures, yet failed to do the same for the Federal Reserve.

As detailed in my written remarks, Dodd-Frank did make some modest improvements in Fed transparency. I commend those. But those should, at best, be viewed as a beginning rather than an end.

Professor Joseph Stiglitz has suggested that an important element of accountability for a central bank in a democracy is for its decisions to be representative of that society. Section 10 of the Federal Reserve Act attempts to manage a degree of representativeness with Board appointments. The ranking member referenced juries. I think we would all want to believe that juries should be representative of the population. So should the Federal Reserve.

For instance, Section 10 prohibits having more than one board member from the same bank district. Unfortunately, that prohibition has been repeatedly violated. I suggest Congress remedy that by specifying the Act's diversity requirements in greater detail. I will note, for instance, that the Board currently has only one member from a district west of the Mississippi River. The Board has over time come to be dominated by D.C. and New York interests, which reduces both its legitimacy and its effectiveness in conducting monetary policy.

Greater oversight of the Fed is also merited given the expansions of its actions beyond monetary policy. Many of the Fed's actions during the crisis were fiscal in nature, such as the rescue of AIG. Some monetary decisions, such as the purchase of agency mort-

gage-backed securities, also moved into the area of credit allocation. The more the Fed decides to pick winners and losers in our society, the greater the need for oversight by democratically elected officials.

Ultimately, both transparency and accountability would be improved if the Fed's behavior were more rule-bound. A large economics literature exists making the case for rules over discretion, to which my fellow panelist, Dr. Taylor, has contributed.

There is related literature in behavioral economics and clinical psychology. Nobel-Prize-winning economist and psychologist Daniel Kahneman has documented the conditions under which we should prefer rules to discretion. His conclusion is, "To maximize predictive accuracy, final decisions should be left to formulas, especially in low-validity environments." I would submit to the committee that monetary policy is the poster child for a low-validity environment.

It is not simply a question of getting the right people to engage in monetary policy. Any set of experts will be subject to behavioral biases that will result in performance that would be inferior to rule-bound decision-making.

Ulysses was wise enough to recognize his inability to resist the siren songs. If we hope to avoid our current cycle of asset booms and busts driven primarily by monetary policy, then we too must embrace that wisdom.

I look forward to your questions and comments. Thank you.

[The prepared statement of Dr. Calabria can be found on page 34 of the appendix.]

Chairman DUFFY. The Chair now recognizes Dr. Kupiec for 5 minutes for a summary of his statement.

**STATEMENT OF PAUL H. KUPIEC, RESIDENT SCHOLAR,
AMERICAN ENTERPRISE INSTITUTE**

Mr. KUPIEC. Chairman Duffy, Ranking Member Green, and distinguished members of the subcommittee, thank you for holding today's hearing and for inviting me to testify. I have submitted detailed written testimony which I can only summarize in my oral remarks.

The Federal Reserve was created by Congress, and Congress has the duty to oversee this creation. The Fed's methods for implementing monetary policy have changed drastically since the 2008 financial crisis. Many significant Fed policy changes merit deeper congressional investigation.

Some of these include the FOMC's recent decision, without congressional input, to reinterpret price stability to mean annual expected inflation of 2 percent; the practice of continuously re-defining the target rate of unemployment that will trigger higher interest rates; claims that the prolonged zero-interest-rate policy promotes economic growth without creating conditions that lead to serious financial instabilities; and credible assurances that the Fed's dual mandate of price stability and maximum employment will not be sacrificed to international pressures should financial market panics occur in Europe, Asia, or elsewhere.

Many Federal Reserve regulatory activities also merit closer congressional oversight. For example, Congress should exercise much

closer oversight over the Fed's involvement with international standard-setting bodies, particularly the Financial Stability Board (FSB). The Fed is a key member of the FSB. The FSB formulates global financial stability policies, it designates globally systemically financial institutions, and it crafts international supervision agreements for their regulation and the regulation of international financial markets and institutions, and it sets capital regulations for these firms.

The FSB's goal is to impose uniform international financial stability policies on its members, and so it is no coincidence that FSB agreements subsequently become U.S. financial regulatory policy. The Fed should inform appropriate congressional committees before it negotiates and finalizes FSB policy directives, as these directives look a lot like international treaties, at least to me.

To date, FSB designations have presaged all FSOC designation decisions, which raises questions about the integrity and independence of the FSOC designation process. The FSB, you may recall, published a list of insurance G-SIFIs, and later these same G-SIFIs were designated by the FSOC despite protests from multiple U.S. insurance regulators. Many assume that this pattern will be repeated when the FSOC addresses shadow banking and other insurance designations.

In a second example, Congress should examine the recurring Fed holding company stress tests mandated by Section 165 of the Dodd-Frank Act. These stress tests are very expensive, both for banks and for bank regulators, and yet there is no evidence that these tests are a cost-effective method for supervising individual financial institutions or for identifying hidden risks in the financial sector.

Since stress test models have large estimation errors, Fed stress test outcomes are at best merely wild guesses (WAGs) of how these individual institutions will perform under imaginary stress conditions. Under the stress tests, the Fed imposes individualized regulatory requirements on institutions. Sometimes these are punitive, but there is no mechanism to appeal disputed Fed judgments to independent arbitration.

The arbitrary and uncertain character of these tests makes it difficult for banks to anticipate their capital needs and plan for the future.

Congress should also exercise much closer oversight over the Fed's new regulatory responsibilities in the insurance industry. The Fed is now examining insurers that have long been examined and are still being examined by State insurance supervisors. About one-third of the insurance industry is now facing Federal Reserve supervision. For these firms, the Fed is now imposing bank holding company standards on top of the capital standards set by State insurance regulators.

The Fed is also involved in international bodies that set international capital standards for insurers, and there is fear within the industry that bank-like capital standards will be imposed on insurance firms throughout the United States.

The Dodd-Frank framers were careful not to create a national insurance regulator, and yet the Fed is taking steps that make it, de facto, a national insurance regulator.

The Fed is also opaque on a number of other issues. It sets its own accounting standards, and these standards deviate from generally accepted accounting principles (GAAP) in ways that may obscure the Fed's true financial condition, especially when interest rates begin to rise to more normal levels.

They also act as if they are shielded from disclosing operational details that are routinely disclosed by other government agencies, for example, information on staff salaries, benefits, and hiring practices, and most recently by refusing to answer congressional requests for information on Fed investigations into FOMC information leaks.

Congress must step up oversight, and insist on greater Fed transparency.

Thank you.

[The prepared statement of Dr. Kupiec can be found on page 47 of the appendix.]

Chairman DUFFY. Thank you.

The Chair now recognizes Dr. Taylor for 5 minutes for a summary of your statement.

STATEMENT OF JOHN B. TAYLOR, MARY AND ROBERT RAYMOND PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY

Mr. TAYLOR. Thank you, Mr. Chairman, and members of the subcommittee, for inviting me to testify today.

One of the, I think, most productive ways to assess the committee's and the Congress' concern about lack of transparency and accountability at the Fed is to look at the trends and what has happened in recent years.

As I look back, I see that one of the most important transparency and accountability reforms, say in the last quarter century, was the Fed simply announcing its target for the Federal Funds Rate. That was in 1994. Before that, people had to guess what the target was; they had to read the tea leaves. And I think that lack of transparency gave an advantage to those who were able to get the information. It also caused considerable confusion about what the target was. The reform fixed that.

The Fed took a number of additional steps in more recent years, I think, to increase transparency, including releasing projections of forecasts and interest rates, holding quarterly press conferences, announcing a numerical target of 2 percent for the inflation rate.

However, there have been important countervailing trends, in my view. For example, in 2000 the Fed stopped reporting ranges for future growth of the money supply as part of its policy, removed those as part of the process when the requirement to report was removed from the Federal Reserve Act by the Congress. While dropping reporting about money growth might not seem that significant, I think it is symptomatic of a broader lack of transparency about the Fed's reporting its strategy for the instruments of policy, whether it is money growth, the Federal funds rate, or some of these unconventional policies, such as quantitative easing.

One reason that there has been a reluctance of the Fed to report or be transparent about its strategy for setting these instruments in some of the newer tools, the unconventional tools, is that it is very difficult to do so. With regard to unconventional tools, their

estimated effects are uncertain. There is disagreement. It is very hard to stipulate a strategy. In fact, some Governors have tried to do that and have found it very difficult. To me, that is a clear disadvantage of these unconventional tools.

But another reason to be reluctant on the part of the Fed reporting its strategy is it thinks that simply setting the goals for inflation or other variables is sufficient. I think that is an incorrect view. I think you need to stipulate the strategy.

May I bring the committee's attention to the Fed's statement of longer-term goals and monetary policy strategies, a particular document the Fed has released in 2012 and has updated? If you look at that document, you can see that the goals are stated, such as the 2 percent inflation rate, but there is no strategy, despite the title of the document, for achieving those goals.

At least, it seems to me, the Fed should be reporting its strategy, certainly the rules or strategy that it uses internally. That is simply a matter of transparency. It is hard to see how one would object to that.

I also think this current environment, where there is a lack of transparency about the strategy, creates the possibility where some can benefit and some can't from the lack of information. I think the controversy over the alleged leak of information in October 2012, is an example of this. Again, since it is so hard to formulate a strategy, it inevitably becomes something where people want the latest information about the unconventional policy. And I think that is the nature of that alleged leak back in 2012.

If there were a clear and publicly announced strategy for setting the instruments of policy, I think these kinds of events would be far less likely. The information would be available to all, and it would be as close as we can come to doing that.

So in sum, while changes at the Fed, such as the establishment and announcement of a numerical inflation goal, have increased transparency and accountability in recent years, as is frequently emphasized, I think a reluctance to establish and announce a strategy to achieve those goals has created an important offsetting countervailing trend. So in my view, the resulting lack of transparency and accountability mentioned in the title of this hearing needs to be reversed.

Thank you.

[The prepared statement of Dr. Taylor can be found on page 65 of the appendix.]

Chairman DUFFY. Thank you, Dr. Taylor.

The Chair now recognized Dr. Rivlin for 5 minutes for a summary of your testimony.

**STATEMENT OF THE HONORABLE ALICE M. RIVLIN, SENIOR
FELLOW, ECONOMIC STUDIES, BROOKINGS INSTITUTION**

Ms. RIVLIN. Thank you, Mr. Chairman, and Ranking Member Green. I am delighted to be back in this room again. The last time I was here, I was actually invited to the full committee by Chairman Hensarling. So I have switched sides.

The premise of this hearing appears to be that there is something mysterious and opaque about the Federal Reserve's conduct of monetary policy and some threat to our economy might unfold

out of view of the Congress and the public, and if another group of experts appointed by the Congress were to get in there, we would learn something important and be better off. My views are quite different, and let me make three basic points.

First, current monetary policy alternatives are controversial, but they are not mysterious or opaque, and Federal Reserve officials are making extraordinary efforts to explain to Congress and the public the dilemmas that they face. Right now, the Fed is making a fairly simple choice. It is deciding when to raise interest rates, short-term interest rates, and how fast to do that. Like a lot of monetary policy decisions, this is a judgment call, views differ—I am sure they differ on this panel—and you can make an argument on both sides.

But I don't think the Fed is being at all mysterious about this. Besides the advances in transparency that Dr. Taylor alluded to, the minutes are much more explicit than they used to be, they come out sooner, the Chair and other Fed officials explain their views frequently and lucidly in speeches. The Chair made a dandy speech in Cleveland this week. She will be here tomorrow. She answers questions endlessly. She holds press conferences after the FOMC.

There was a time, when I was at the Fed in the 1990s as Vice Chair, that we were a lot more mysterious. But there has been a lot of progress.

Second, I think nothing terrible or irreversible is likely to happen if the Fed acts too quickly or too slowly at the moment. The threats to our future prosperity are much more likely to come from fiscal gridlock.

At the moment, inflation is not a danger. It is very hard to see any way that inflation could take off suddenly and get out of hand. Our economy is simply much less inflation-prone than it used to be.

Unfortunately, the dominant scenario for the future is slow growth in the labor force and in productivity. Fiscal policy has a chance to turn that around by investing in infrastructure and science and in the skills of the labor force and by offsetting those investments with long-term control of our rising debt. I think that is a very great responsibility, and it is a responsibility of the Congress and the President, not the Fed.

Third, monetary policy decisions can be politically unpopular, and the creators of the Fed were wise to insulate those decisions from political pressure. Injecting another group to second-guess monetary policy decisions would undermine an independent agency which is working hard to do what Congress created it to do.

Monetary policy decisions are hard, and they have often been made mistakenly. I wouldn't say the Fed has always been right. But they are hard, and often the important thing to do is very unpopular. And it is for that reason that I think the Congress should not want and did not want when it created the Federal Reserve to make monetary policy itself. Delegating monetary policy to an independent body was a sound idea, and it is working quite well, so I would advise you to leave well enough alone.

Thank you.

[The prepared statement of Dr. Rivlin can be found on page 62 of the appendix.]

Chairman DUFFY. I appreciate the panel's testimony. The Chair now recognizes himself for 5 minutes for questions.

I want to talk about the Medley leak to start. Here you have a well-connected group that is able to access private information. The way we learned about it is because they stupidly sent out an email the day before to everybody with this private information, which begs the question, does this happen more often than we actually hear about?

But I think in regard to transparency, I don't usually agree with Elizabeth Warren, but when she talks about the game being rigged, isn't this a perfect example of where if you are powerful, if you are well-connected, the game is rigged against those who aren't? You can get information from insiders at the Fed if you are well-connected, but if you are not, you are like the rest of us without good quality information that comes from the inside.

Am I wrong on that, Dr. Calabria?

Mr. CALABRIA. I think you are absolutely right on that. And I want to emphasize something that Dr. Taylor touched upon, which is, if we had a predictable rules-bound policy that any outside objective observer could figure out the direction of the Fed, then the value of these leaks and trying to gather inside information declines.

Chairman DUFFY. It takes away the incentive to game the system, right? It takes away the power of those who are well-connected as opposed to everyone being treated fairly. Am I correct on that?

Mr. CALABRIA. Yes, Absolutely.

Chairman DUFFY. Dr. Taylor, do you agree?

Mr. TAYLOR. I think, Mr. Chairman, you listed some of the concerns that there are about having leaks. That is why there should be efforts to prevent that. It does give certain people advantages and leads to concerns about connections.

Chairman DUFFY. Dr. Kupiec?

Mr. KUPIEC. It certainly would make the problem less severe. I think if there is a monetary rule, if the Fed were bound by some of Dr. Taylor's suggestions, they would still deviate from the monetary rule from time to time and inside information would still be valuable, but it wouldn't be to the same degree that it is today. It would be far more predictable and there would be less ability to sell inside information.

Chairman DUFFY. Dr. Rivlin?

Ms. RIVLIN. Leaks are a bad thing no matter what your strategy for making monetary policy. There is no excuse for leaks, and they ought to be ferreted out and punished.

Chairman DUFFY. And would transparency, in some of the reforms we have been talking about, help with the lack of need for that insider information?

Ms. RIVLIN. No, I don't think so. As long as the Federal Reserve is charged with setting short-term interest rates, there are people who are going to profit from knowing that information in advance, and they should not have it.

Chairman DUFFY. In regard to congressional oversight, Dr. Rivlin, I am not sure if you followed the leak at all, but we have

asked continuously for information in regard to the internal investigation at the Fed. We have asked for information from the IG.

Now, this is not about monetary policy, contrary to what the ranking member was talking about, this is about our investigation into the leak. You would agree that Congress has the right to oversee internal policy inside the Fed in regard to these leaks, what kind of investigation they did, what kind of recommendations they gave to the FBI or to their IG, you would agree with that, correct?

Ms. RIVLIN. I am not an expert on how you prosecute leaks. They have turned it over to the Justice Department, which seems to me appropriate.

Chairman DUFFY. But you are not saying that Congress doesn't have a role to garner information, right?

Ms. RIVLIN. Congress certainly has a role, but I am not sure that second-guessing the Justice Department when it is trying to investigate a leak is a productive thing to do.

Chairman DUFFY. I would just point out that no one is second-guessing Justice. But Justice doesn't prohibit Congress from accessing information. An IG investigation doesn't prohibit Congress from accessing information. It is pretty clear that we are entitled to do a complementary investigation of anyone else who is doing one out there in regard to these leaks.

It is serious stuff. And, frankly, the length of time it has taken to actually get the ball rolling on an investigation concerns many of us. And the fact that we are 3 years later and only by congressional push do we have people actually looking into the leak, I think the evidence would show that some folks inside the Fed wanted to sweep it under the rug.

Quickly, Dr. Taylor, you have expressed your concern in regard to transparency in how the Fed operates and implements monetary policy. We have been talking about this FOMC leak from 2012. Do you see a connection between those two?

Mr. TAYLOR. I do, because if there is really no way to describe the strategy of the Fed, if it is completely discretionary, if there is a decision which is made each time that is unrelated to the previous ones, yes, it creates the opportunity for more things to be selectively leaked out.

So I think the more transparent the Fed can be with respect to its strategy or its operations, the less chance there is for such leaking. It doesn't eliminate it, of course. There have to be ways to prevent it and take actions if it occurs. But it reduces the chances.

Chairman DUFFY. Thank you.

My time has expired. The Chair now recognizes the gentleman from Missouri, Mr. Cleaver, for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman.

Dr. Calabria, let me just tell you how strongly I support your concern about members of the Fed west of the Mississippi, in spite of the fact that my State is the only State with two Fed offices. But the reason I do has nothing to do with this hearing except for the fact that the Federal Government leans to the East Coast in almost everything, including spending.

And that is why I am an obsessed person as it relates to earmarks. It is one of the dumbest things that I think we could do, is say I was elected by Congress and the Constitution gives us the

right to spend, but we are going to give it to the President and the Administration.

And the money continues to lean toward the East Coast. It doesn't cost the taxpayers one penny more than what the budget is approved for operation. But all of this misinformation is out in the world, and we are going to continue until we change the lean to the East Coast. And I don't intend to live on the East Coast. There are some nice people there. I am not mad at any of them, just as I am not upset with you from our last meeting.

But the other thing is, I also think that it is important for us to all make sure we understand that this is not about who supports trying to investigate the leak. In my real life, I am a United Methodist pastor. If you leak information, if you talk about confidentiality, the bishops, you are out of the church. So I feel very strongly about it, and I think we ought to prosecute to the fullest extent if the FBI can get to the bottom of this. The other thing is, I support the chairman in calling for this investigation and information to come to this committee.

My concern, though, is that I think—we almost had a bill approved, the Federal Reserve Transparency Act, which required a number of audits, some of the things that we have been talking about here. The chairman might remember—and it was bipartisan, incidentally, strongly bipartisan, not the normal stuff that we say bipartisan when it is one Member from the other side. I think we had almost 100 Democrats on the bill. It was introduced, as I recall, by Ron Paul.

And we were going to pass it up until the last day, until there was an amendment by Congressman Watt from Charlotte. And I think that if we have a spirit of working together again, we could probably deal with some of the issues about which we may have some mutual concern.

But my question is, and I would like to ask Dr. Taylor, if not the Fed, then who? We have a number of responsibilities that must be operated to preserve our economy, and if the Fed doesn't do the monetary and credit oversight or the supervision and regulation of banking or providing financial services to depository institution, who does it? Do we just forget it? Or do we pass it on to another agency? What happens?

Mr. TAYLOR. There is no question that with respect to monetary policy, the Fed has the responsibility. And Congress has oversight. But it has been given that responsibility. And I think that, in principle, is the way it should be.

When you go beyond monetary policy to regulatory matters, then there are, of course, other agencies, Federal agencies and State agencies who can, and sometimes they are better off doing this.

There seems to me a disadvantage to having one agency do everything. It creates more power than I think is necessary. So, there has been a delegation to different agencies, some Federal, and in our system, some State. It seems to me that makes sense.

One can worry about how that organization takes place. So one of the things that happened in Dodd-Frank was to merge the Office of Thrift Supervision into the Comptroller's Office. That made sense. There was some bringing together of things that shouldn't

have been separate. So you can think about it, but it seems to me, with respect to monetary policy, the Fed has the responsibility.

I would add one thing. If an agency expands its mission, what is frequently called mission creep, then I think there is a concern. We have in our system a way to separate powers, that Congress has roles for appropriation, for example.

And I would just add perhaps on the side to your question about putting the agency in charge of the financial issues in the Fed, without the scrutiny of the appropriation process, seems to be not in the direction, that is in a sense giving extra power to an agency, talking about the Consumer Financial Protection Bureau, of course, which doesn't seem appropriate.

Mr. FITZPATRICK [presiding]. The gentleman's time has expired.

Mr. CLEAVER. Thank you, Mr. Chairman.

Mr. FITZPATRICK. The Chair recognizes himself for 5 minutes.

Chair Yellen, who will be before the full committee tomorrow, has recently admitted that she had a meeting with Medley Global Advisors. They are, of course, the political intelligence firm that obtained the leaked information, FOMC information.

Dr. Calabria, should members of the Board of Governors of the Federal Reserve be speaking with political intelligence firms who are in the business of selling their clients access to the political decision-makers?

Mr. CALABRIA. I lean toward feeling the Fed should be open to meeting with just about anybody who wants to meet with the Fed. I think the importance is, you have to be aware of when you are meeting. And, again, it is very difficult when you are having a conversation with somebody to be guarded about what you say. But I do think that if the Fed is going to meet with political intelligence firms or market analysts in general, it has to sit down with the understanding of it is really there more to listen than to say anything.

Mr. FITZPATRICK. Dr. Kupiec, what are the risks?

Mr. KUPIEC. Pardon me?

Mr. FITZPATRICK. What are the risks?

Mr. KUPIEC. I think the risks are what you see now. I think there have to be limits on this, definitely. I worked at the Federal Reserve for 10 years, so I am very familiar with what goes on. I saw past division directors who went to work for Wall Street firms or intelligence firms regularly come back and talk with Governors and all of that seemed highly inappropriate to me.

I share Mark's opinion that the Federal Reserve in its communications with the public in general has to meet with people who want to meet with it occasionally, but you can limit these things. For example, Federal Reserve Governors—according to the Government Sunshine Act, you can't have more than, I forget how many, three or four of them meeting at any one time or it has to be declared a meeting. So they can't even talk with the other Governors in private. So I think there are definitely rules that could be put in place to limit this.

Mr. FITZPATRICK. Dr. Kupiec, in your written testimony you wrote that the practice of continuously redefining the Fed's target rate of unemployment that is consistent with "maximum employment and price stability," you indicated that is a change in mone-

tary policy that would mandate a required deeper congressional oversight or investigation.

Mr. KUPIEC. I think the Fed has changed its operating policies to such a degree since 2008, and many of these things are big deals. The QE policies. Their mandate is price stability, yet in 2014 they redefined price stability to be 2 percent annual target inflation rate. Now, inflation targeting is common, but they did that without any consultation with Congress, without any discussion.

Price stability is not the same thing as a constant inflation rate. Those are not the same things. There should have been discussion. There should have been oversight. There should have been consultation.

The unemployment rate, it is the thing that we discuss over and over again. One of these days, we are going to hit the right unemployment rate in the next 2, 3, 4, however many years, where the Fed is going to raise rates. But there is no way you can tell from the discussion that goes on what the target rate is.

So this interjects the uncertainty. It gives rise to the insider information and the problems we see. Something that is more constrained by some kind of stated target would be much more acceptable or at least some discussion with Congress about that.

Mr. FITZPATRICK. Dr. Calabria, increasingly it seems that our regulatory regime is being dictated by international organizations—one example is the G20's Financial Stability Board—instead of organizations that would be more inclined to promote the interests of the United States of America. Why do you think this is occurring?

Mr. CALABRIA. I certainly think we need to be very concerned when you see these designations, then therefore FSOC follows up and the pressure comes there. So certainly as a start, in my opinion, the U.S. representative should not be voting for any sort of delegation of a U.S. firm that FSOC itself has not already voted on. The process needs to start there rather than the other way around.

Certainly, and we saw this come out during the trade debates and it is just as relevant here, the extent to which we actually see these regulatory bodies engage in treaty-making. And I think that is a very real concern and there has to be vigorous oversight of that area.

Mr. FITZPATRICK. What are the long-term risks of ceding the authority?

Mr. CALABRIA. I think the risk there is that you get decisions made that aren't necessarily democratically accountable. You don't get decisions that are input from other regulators. So FSOC, for instance, was meant to be a process where the other regulators would have some input. So, for instance, when the Federal Reserve might go to the Financial Stability Board and discuss insurance companies without having the insurance representatives of FSOC as part of that process, that cuts out that ability for FSOC to be truly representative of the agencies in question.

I am not a fan of FSOC, but we decided to set it up, and we decided to set it up to concentrate this decision-making in that body, and therefore the Fed and Treasury and others should not be making decisions that are within its jurisdiction.

Mr. FITZPATRICK. Thank you for your response.

The Chair now recognizes the gentleman from Virginia, Mr. Hurt, for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman.

I thank the members of this panel for joining us today. I had a question that might be a little larger than looking at specific situations where we need more accountability in a granular level. I was struck by a phrase that you used, Dr. Calabria, in terms of the role of a central bank in a democracy, the role of a central bank in a democracy. And I start from going to our Constitution, which of course sets out our legislative powers in Article I and the executive powers in Article II.

As we have seen over recent years, and this has been of course exaggerated by the Dodd-Frank Act, the Fed has an enhanced role in policymaking, more regulatory powers, more policymaking powers, as opposed to just monetary policy.

Yesterday, Chairman Neugebauer hosted a roundtable on the issue of liquidity in the corporate bond market. And the question of course is whether or not the market is liquid and can withstand future stress and the risk that poses to pensioners and, ultimately, to taxpayers.

I think it is ironic, and I think my constituents in Virginia's Fifth District would find it ironic that you look at a housing policy prior to 2008 that fueled a bubble that burst and left homeowners and taxpayers on the hook. Here, in response to the crisis in 2008, we have a zero-interest-rate policy that has fueled a corporate bond market or bond issuance on the one hand, and now you have the Federal Reserve playing a major role with the right hand in strangling that capacity to be able to absorb those issues in the marketplace.

And so I guess my question, and I would ask Ms. Rivlin to begin and then go to Dr. Taylor and then Dr. Calabria, but from the larger standpoint, from a structural standpoint, should we be concerned about this, about the amount of power that the Federal Reserve has as part of the policymaking that has such an important effect on our economy? And where is the accountability to the American people who ultimately should hold policymakers accountable?

Ms. RIVLIN. Yes, I think you should be concerned about it. I do believe you need to set monetary policy, an independent central bank, and we have one.

With respect to regulatory policy, I think there are some serious issues here. When you passed Dodd-Frank you opted to, for a very complicated structure, keep a lot of the supervision and regulation in the plethora of agencies that were doing it, only abolishing one, creating the FSOC, and giving the Fed responsibility, which I think is appropriate, for major systemic risk. But the situation is very complicated. When I originally testified on Dodd-Frank, I was more in the Dodd camp, that you should consolidate the regulators.

Mr. HURT. And I don't mean to cut you off, but I would say that the question is, I don't think the Constitution in Article I says that Congress has power to legislate in everything except complicated matters. And I guess that is my concern.

Dr. Taylor, and then Dr. Calabria?

Mr. TAYLOR. I would just say, yes, I agree completely, you should be concerned about overreach. I think just one of the things, for example, that has concerned me is some of the unconventional policies where massive purchases of mortgage-backed securities. It seems to me that is beyond the usual purview and does get into the area of credit policy and fiscal policy of the Congress.

Mr. CALABRIA. I certainly share those concerns. As I mentioned earlier, I would get the Fed out of bank regulation. Certainly, there are going to be some downsides to that, but I think the upsides are better, and I think it would actually improve the independence of monetary policy. And of course try to get the Fed out of things that clearly look fiscal will keep them out of some of these arguments.

Mr. HURT. Thank you. I yield back my time.

Mr. FITZPATRICK. The gentleman's time has expired.

The Chair recognizes the gentleman from South Carolina, Mr. Mulvaney, for 5 minutes.

Mr. MULVANEY. I thank the gentleman. And I thank all of the panelists for doing something that I welcome the opportunity to do, which is to sit and talk about an issue for a while, as opposed to try and make political points.

Ms. Rivlin, during your opening statement you said something that I thought was very accurate and very insightful, but I hope you understand that there is another side of the coin, which is you mentioned the importance of the Fed, the independence of the Fed in making monetary policy and making politically unpopular decisions.

I think that the difficulty that many of us perceive on this side of the aisle is that hasn't happened nearly enough for the last 8 years and that the risk that we see is that the Fed will lose its ability to make unpopular decisions and simply make a bunch of popular decisions. It has been easy politically to keep rates at zero for a long period of time, along with some other decisions that they have made.

So we are worried about the Fed's ability to do exactly what you just talked about, which is make difficult decisions, especially when it comes to Wall Street.

Would you agree with me, by the way, Ms. Rivlin, and I am just thinking off the top of my head, that sometimes you will be called upon to make, at the Fed, decisions that are bad for Wall Street? Or do you think that what is good for Wall Street is what is good for the country?

Ms. RIVLIN. I think it is a question of long run and short run. Whoever regulates Wall Street has an enormous responsibility to avoid what happened in 2008. We can't afford that again. And I think that regulation, if a bubble is imminent or on the horizon, is going to be seen as inimical to Wall Street. It will involve raising capital standards and limiting liquidity, all of those things the big banks will say is terrible. They will need to be done to avoid another crash. And in the long run, Wall Street and Main Street benefit from having a strong economy and one that does not repeat the mistakes of 2008.

Mr. MULVANEY. And certainly I agree with that. I guess I just ask you to consider as you go forward and you look at this issue that some of us, myself included, are concerned about what we per-

ceive as, this is not the right word, but the parallel would be regulatory capture within the regulatory agencies, that the Fed becomes so close to Wall Street that it becomes incapable of making a decision that would be against the short-term interests of some of the folks whom it oversees.

But that is not what I want to talk about. Dr. Kupiec, I want to talk about what we came here today to talk about, which is some of the things we can do better going forward on Fed oversight. And you mentioned something that was of interest to me. We have had a couple of hearings these past months on the IMF, and you said to pay closer attention to the international regulatory bodies. Tell us a little bit more about that and what you think we might be able to do on that front.

Mr. KUPIEC. I think there have been bills already introduced that would require, in the Senate at least I think the bill was introduced, that would require the Federal Reserve to give the appropriate committees notice before they go to negotiate on international agreements on capital or G-SIFI or anything like that, and give appropriate notice to Congress and the public, and to come back and report on the outcome of these negotiations. And I think steps like that would be very helpful.

Mr. MULVANEY. Have you ever given any thought to the role that the international groups play on monetary policy? I saw something that I guess is not unusual, I have not paid any attention to it before. About 2 weeks ago, the IMF came out with, not a recommendation, but a view that the Fed shouldn't raise interest rates, it would be bad for the U.S. economy and the global economy. Should we be concerned or at least should we be paying attention to the types of exterior influences that those groups have on the Fed?

Mr. KUPIEC. I think the Fed demonstrated in 2008 it was really the central bank to the world. And I think these international pressures to influence domestic monetary policy, policy that should be targeted at domestic U.S. interests, will come.

And I think you could interpret the Lagarde comments, the IMF comments two ways. It could be giving the Federal Reserve cover not to raise rates, even though they had telegraphed it for the last so many years that eventually rates would rise and it gives the Fed an excuse not to raise rates. But you could look at it the other way, that there will be international pressures. I think in the future, when other parts of the world stumble badly and they want dollar liquidity, there will be push to have the Federal Reserve act.

Mr. MULVANEY. Dr. Taylor, very quickly, because I have very little time, you mentioned in your opening statement about the new document, the statement of long-term goals and monetary strategy, and you said that it was a little short on strategy. What would the objections be, do you think, sir, to doing what you suggested, which is being more articulate in strategy going forward?

Mr. TAYLOR. One objection is that they say we don't need to tell you our strategy, we just tell you our goals and you let us do whatever it takes to achieve the goals. It is a view, I disagree with that, but that is what has been stated—look, we gave you the goals, what more do you want? I think in a way, the goals distract. They are good, but they can distract from what the strategy is.

Mr. MULVANEY. Thank you.

And back to the original point, Mr. Chairman, I think what concerns me is that when they don't lay out the strategy, we do end up with these extraordinary measures that we didn't even know were on the table. Taking a balance sheet to \$4 trillion is something that I don't think anybody expected going in. So I happen to agree with Mr. Taylor that we may want to push them more on what tools they decide to use to get to their goals.

I yield back. Thank you.

Mr. FITZPATRICK. The gentleman's time has expired.

The Chair recognizes the gentlelady from Ohio, Mrs. Beatty, for 5 minutes.

Mrs. BEATTY. Thank you, Mr. Chairman.

And thank you to our ranking member.

I also thank our witnesses for being here today.

I believe as I was coming in, Mr. Kupiec, I heard you talking about employment and price stability. While certainly, as we know, the United States economy continues to recover, it is important for us to understand the Federal Reserve's dual mandate to achieve maximum employment and price stability, as well as to understand that Congress continues to have oversight of the Fed, but to allow the Fed's monetary policy independence to achieve what I am going to refer to as these "twin goals."

So, I would like to discuss the Fed's role in bank supervision. I think the Federal Reserve's Governor stated: The most important contribution we can make to the global financial system is to ensure the stability of the United States' financial system. So when we think of that, when we think of the \$50 billion asset threshold, which I am on the record as saying that I think it should be higher, and while we talk about how a \$100 billion asset threshold might make more sense, I don't know that I agree with a threshold alone being enough to warrant how we treat the banks and how we label them.

My question for the panel is, was Dodd-Frank's Section 165, enhanced supervision, supposed to apply to firms that lack systemic importance to the stability of the United States financial system? And if not, what are those domestic effects on having regulators apply enhanced supervision to such institutions?

Mr. KUPIEC. Thank you.

Section 165, if you read it, and I am sure you have, it is about financial stability. The enhanced prudential standards are standards that are supposed to be imposed because the firms they are imposed on, if they were to get into financial distress, could cause a crisis. They could cause financial markets to lock up, to dysfunction. And so the whole idea that a \$50 billion dollar institution could bring the U.S. financial markets to its knees, I think is crazy. The \$50 billion threshold is way too low.

Last week, I testified in Chairman Neugebauer's subcommittee, the Subcommittee on Financial Institutions and Consumer Credit, on a more appropriate way to designate institutions, and this is going back to the modification of Congressman Luetkemeyer and his colleagues' bill where the FSOC would consider designations.

But to differ from Congressman Luetkemeyer's bill, the whole financial systemic risk debate has moved to designating subsidiaries

as critical for the financial system. So if you look at the resolution policies that now are being promoted internationally and domestically by the FDIC, they say what you really have to do to maintain financial stability is if a firm gets into trouble, you have to keep the subsidiaries open and operating to prevent financial systemic risk.

And so what I would argue is, you would look at the subsidiaries and designate subsidiaries as being the systemically important subsidiaries, and that would take away the whole threshold. So you could be a large firm, but you could be well-diversified and have a number of small subsidiaries and none of them might be critical for the function of the financial market.

So I think it really is the way the resolution ideas are moving, and it would mandate legislative changes to Section 165 of the Dodd-Frank Act in how we designated firms.

Mrs. BEATY. Okay. In my last few seconds, certainly you know by law that the Federal Reserve conducts monetary policy to achieve maximum employment, stable prices, and moderate long-term interest rates.

Dr. Rivlin, would you please discuss, to the best of your knowledge, what effects Federal monetary policy has, if any, on employment and perhaps through sustained low interest rates on wage growth?

Ms. RIVLIN. The Fed has several ways of affecting the level of activity in the economy. The most obvious one is control of short-term interest rates. And in an economy that is operating below its potential, and recently we have been way below our potential, it can stimulate some investment and activity by keeping rates low.

During the recent years, they also realized they needed to keep long-term rates low, and that was the reason for the bond buying quantitative easing.

These are fairly blunt instruments, but they use them as well as they can, and I think by and large, they are doing a pretty good job.

Mr. FITZPATRICK. The gentlelady's time has expired.

The Chair now recognizes the gentleman from Illinois, Mr. Hultgren, for 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman.

And thank you all for being here. I appreciate your work and your words today.

I want to spend just a couple of minutes, and address this to Dr. Kupiec, if I could, talking just a little bit more, and I think at the opening statements of the hearing today, we certainly heard a difference of opinion of the role of Congress in oversight of the Fed and whether that should happen or not, or whether the Fed should be completely independent.

And I see, again, following up on Chairman Duffy's questioning a little bit about the 2012 FOMC leak, it really raises concerns for me and others, but also failure to disclose that to Congress, raises additional concerns as well.

I wonder if you would talk just briefly about the benefits of proper oversight that happen in the marketplace as we are truly doing our job as a Congress to oversee the Fed, but also negative effects if we fail to do our job.

Dr. Kupiec?

Mr. KUPIEC. Congressional oversight is very important. The way the system is working now, the Federal Reserve has been given enormous discretion to craft policies. And these policies, the ones that are being crafted internationally, take a number of years to put in place, and Congress may not revisit them till the end, when all the work is done. And as I say, these things are very much put together like treaties, and it becomes very difficult for the Congress to intervene and to change a process or stop a process if it is not in the direction that was originally intended in the law.

Mr. HULTGREN. So it is important to be part of the process throughout and not jump in just at the end?

Mr. KUPIEC. That is what I elect you for, yes.

Mr. HULTGREN. Yes. I am going to shift and talk a little bit about some other questions I have.

Dr. Taylor, if I can address some questions to you. And really looking at these last 6 years, I would say, have been defined by the Federal Reserve's exceptionally interventionist and discretionary monetary policy. I would say thus far this monetary experiment has not produced desired results, but has created enormous amounts of uncertainty about the future.

As we are moving forward and we see the Fed has ended its quantitative easing program and is beginning to think about raising interest rates, which we think might happen soon, are we approaching a point where a rules-based approach to setting interest rates, an approach you have supported in the past, would again be useful? And if we do see that type of approach, what type of transparency would also come along with that?

Mr. TAYLOR. I certainly think we have come to the point where such a process would be useful. I actually think it would have been useful a little earlier, to be sure.

Mr. HULTGREN. Me, too.

Mr. TAYLOR. Just to elaborate, I think the Fed's actions in the panic, lender-of-last-resort actions, have done a lot of good, it was basically hard to disagree with that, details of course. But before that, I think what Mr. Calabria mentioned, the rates being so low, which helped induce some of the excesses, that was really not according to the rules that worked in the 1980s and 1990s. And then subsequently to that, the unconventional policies, et cetera, I think, were not effective.

So the sooner, the better, in terms of getting back to the things that worked, is the way I would put it, the things that worked in the past, we would be better off doing that.

Mr. HULTGREN. What can we do to help push that? What do you think our role ought to be in that?

Mr. TAYLOR. I think the best thing is to ask the Fed to describe their strategy, then there can be a discussion about it. Without going much further, I agree with the sentiments that this committee, and the Congress cannot micromanage the Fed, and shouldn't be doing monetary policy. But it can ask the Fed to describe what its policy is, what its strategy is. It can even say: Change it, if you want, but tell us why. It seems to me that is part of the oversight, part of the accountability, and I think that is what the Congress could do.

Mr. HULTGREN. I think that is a good balance. And it doesn't have to be either/or, either we are completely involved or completely hands off, but, again, recognize that we do have a role there.

Dr. Calabria, do you have any thoughts on that? Do you agree with Dr. Taylor on this? Are there other suggestions you would have for us?

Mr. CALABRIA. Absolutely. I think the oversight role is incredibly important. And I say this as a former staffer of the Senate Banking Committee. I wish we had done more oversight of the Fed before the crisis, and I think some of this would have been avoided.

It is certainly worth remembering, in talking about the importance of an independent Fed, that the Constitution delegates that authority from Congress. And so it is more likely often than not the Executive Branch which will have incentives for short-term goosing of the economy, if you will. As you know from being up here, the notion that Congress will have one single viewpoint on monetary policy is simply not going to be the case.

So I do think it is important for Congress to serve as an important counterweight to the Executive Branch, which has much more clearly defined incentives in terms of monetary policy.

Mr. HULTGREN. Great point.

Thank you all again.

My time has expired. I yield back, Mr. Chairman. Thank you.

Mr. FITZPATRICK. The Chair now recognizes the gentleman from Maine, Mr. Poliquin, for 5 minutes.

Mr. POLIQUIN. Thank you, Mr. Chairman.

And I thank the witnesses for being here today. I appreciate it very much.

With Chair Yellen coming in tomorrow for her regular testimony, I think it is a great time for us to dig into a little bit about the accountability that the Fed has with respect to regulating our economy and financial markets.

Every day I talk to business owners in our district up in Maine who are encumbered with mountains and mountains of regulations that are preventing them from growing and hiring more people. In fact, they spend more time trying to comply with Federal regulation and more of a cost than they do in selling more of their products.

So I am very concerned about this. I believe there does have to be a balance between fair regulations, predictable regulations, but also not killing jobs.

Now, one of the concerns that I have with the Fed is they continue to push back on wanting their independence, and they should be independent, of course; I think we all agree with that. However, they have also to date failed to comply with subpoenas that have been issued by Congress through this committee.

And so I am a little bit concerned about that. When you look at some of the information that was disclosed in 2012, in a confidential deliberation at the Fed disclosed to one party, such that that Wall Street participant gave special consideration to their clients in violation of the law. And also it put other investors around this country, millions of investors saving for their retirement who were not subject to or didn't have access to that same information. So

I am very concerned about that, and I want to be on record about that going forward.

That being said, I would now like to turn my attention to a slightly different topic. Mr. Kupiec, if you don't mind, I know in the past you have expressed concern about the living will process under the Dodd-Frank set of guidelines or set of regulations. And I believe you are even more concerned that process could be a hindrance to capital formation and growth and what have you in the non-bank financial institution space, specifically with the insurance companies and with asset managers, mutual funds, and pension fund managers.

Now, when you have insurance companies that are already regulated by 50 State regulators and you have investment managers who run \$24 trillion of retirement savings across this country already regulated by the SEC, now the Fed wants to get involved. Could you dig into this a little bit, sir, and tell us what that might look like? And do you believe that the Fed has any experience in this area?

Mr. KUPIEC. Thank you for the question.

The whole issue about whether asset managers and large insurers are systemically important institutions is a sticky one. AIG, of course, needed assistance during the crisis, but that really—the problems at AIG were not inherently from the insurance company parts of it. The insurance companies were completely fine. It was with a derivatives company that was in London, and it was under the Office of Thrift Supervision oversight and just not done very well.

But that carried over. That carried over to the insurance companies after the crisis, and it really isn't warranted. Asset managers—the more we tighten down on banks and bank regulation and we keep people from making—the longer we keep zero-interest-rate policies, that you and I put money in the bank and we earn nothing on it, the more we force investors who need to earn a return on their money to go to securities markets, to go to mutual funds. And so the growth is really in the mutual fund industry.

The harder the Fed and banking regulators squeeze the banks, the more the money flows out, which is quite a natural reaction in markets. But, of course, the regulators want to get ahold of that because the horse is leaving the barn. The game for them is over.

And so what they really want to do, and one of the problems is, is to impose bank-like regulation on asset managers, mutual funds, things like treating money market mutual funds as if they are an insured bank account. They argue, well, we have to—

Mr. POLIQUIN. But if I may, Dr. Kupiec, if you have a couple of asset management firms, those assets are not on the balance sheet of those firms. That is someone else's money that they are managing. So there is no systemic risk to the market, because if there is a problem, the money just goes to another asset manager and the actual securities are held in a trust department down the road.

Mr. KUPIEC. You are absolutely right. There is no leverage. The people who own the mutual funds own the assets. They take the losses. There is no safety net subsidy. There is no reason for systemic risk problem here, in my opinion.

Mr. POLIQUIN. Thank you very much, Dr. Kupiec, for clearing that up for all of us. I appreciate it.

Mr. Chairman, I yield back my time. Thank you.

Mr. FITZPATRICK. The gentleman from Arkansas, Mr. Hill, is recognized for 5 minutes.

Mr. HILL. Thank you, Mr. Chairman. I thank the ranking member as well, and I thank this distinguished panel for being with us today.

I wanted to go back and talk about Section 13(3) authority, and get your views on that subject. We had crashes and depressions for 100 years before the Fed was formed in 1913, and we have certainly had some doozies since 1913. And I would like the panel's views on the Fed's use of 13(3), the Bagehot Rule, to go back to Lombard Street, ancient days; and also your thoughts on whether such power should be somehow limited to just depository institutions rather than the economy as a whole.

I will start with you, Dr. Calabria.

Mr. CALABRIA. Let me peel away the onion of that question.

First, let me start with the nonbankers versus bank latter part of it. So certainly 13(3), in my opinion, is largely for nonbanks, because banks should be able to go to the discount window or other lending functions. So if we want to have nonbanks to have access to some sort of Fed assistance, that is largely going to be 13(3).

My druthers would be not to have that authority at all. If you are going to have that authority, I do think that authority needs to be limited to firms that are indeed solvent and should be broadly available. I will take this as a moment to say the approach that Senators Warren and Vitter have suggested in the Senate, I think, is a wise approach in the step to try to at least add some actual flesh to what Dodd-Frank tries to do in terms of limiting 13(3). But, again, let me end with saying, if I had my choice, we wouldn't have those authorities to begin with.

Mr. HILL. Dr. Kupiec?

Mr. KUPIEC. Banks are special, and we have central banks in part to be able to provide lender-of-last-resort authority to depository institutions when they need it, provided they are solvent, and I think those powers are necessary. Whether the Federal Reserve should have special powers outside of that to other financial firms, I think that has to be limited, much more limited.

Right now, the rules in Dodd-Frank, some would argue that they are too restrictive on the Fed. I think the Fed argues that. But many think that the rules are written in a way—one of the rules is they have to—if they are going to have a special lending facility, it has to be a facility tailored for the whole industry to use. But you could easily tailor a facility that only one firm decided to use, and so there is always a way around the rules. And so many believe these 13(3) rules are not restrictive enough.

I think this issue does need to be revisited, and the Congress should make a decision about how far it wants the Fed to have these special lending powers. I think they are an issue.

Mr. HILL. Dr. Taylor?

Mr. TAYLOR. I think it certainly should be limited, to answer your question. My preference would be to limit it to depository institutions, obviously solvent ones. And this comes to the rules that

you implement and what the collateral should be, what the penalty rate should be. I think the Fed should stipulate what that should be as best as it can, and I would be on the side of limiting it more than others.

Mr. HILL. Dr. Rivlin?

Ms. RIVLIN. One of the main things we learned from the 2008 crisis is that systemic risk can come from every direction. In 2008, it came primarily from nondepository institutions, although it came from all of them. I believe the Fed needed the powers once we were in that situation, which we never should have been, to lend to nondepository institutions as quickly as possible. The rules need to be reconsidered, but I would not make them along those lines.

Mr. HILL. Thank you.

Let's shift gears, Dr. Kupiec, to the issue you brought up in your testimony about the directives from the FSB. And tell me the statute that our regulators implement without discussion, FSB directives. What is the statute in the United States that permits them to do what they are told by the FSB.

Mr. KUPIEC. There is no statute.

Mr. HILL. How do they do that then?

Mr. KUPIEC. It is a mystery.

Mr. HILL. Can you explain the mystery, please, in 9 seconds?

Mr. KUPIEC. The President and the Secretary of the Treasury met in G-20 discussions on or about 2011 and created this international group called the Financial Stability Board that was supposed to make the world safe for all financial markets forevermore. And so they take it as a directive, I think, more from the Executive Branch that the rules crafted in the FSB—somehow they are empowered to put those rules in place in the United States.

Mr. HILL. Thank you.

I yield back, Mr. Chairman.

Mr. FITZPATRICK. The Chair now recognizes the gentleman from Colorado, Mr. Tipton, for 5 minutes.

Mr. TIPTON. Thank you, Mr. Chairman.

I would like to thank our panel as well for being here.

Dr. Kupiec, I appreciated your words when you were talking about uncertainty in the marketplace and a need for clarity. But I think there is a lot of concern when we are talking about transparency and accountability as we continue to see the Federal Government, through a variety of different organizations, continue to extend its footprint in terms of regulatory authority. And I think we can make a very credible argument that if we are not having inflation, we are having taxation via regulation, because ultimately these costs are being passed on to the American consumer, driving up costs.

But what I would like to be able to maybe focus on and get your comments on is we have now a lot of our entities that are looking to be able to get out from under the designation of being a SIFI. We have General Electric right now trying to be able to sell off some of its assets simply to get out from under the designation and the onerous provisions that are going to be inhibiting their ability, and increasing costs for consumers, by the way.

Would you like to maybe speak a little bit about that uncertainty, that lack of clarity that we are seeing out of that designa-

tion process? Is it, to quote your words from just a moment ago, just a great mystery, a guessing game that we are having to play?

Mr. KUPIEC. The designation as systemically important under Section 165 of the Dodd-Frank Act causes a lot of new rules and regulations. One of the most onerous ones is the CCAR stress test, the big stress test that the Federal Reserve Board does annually. And one of the reasons is because it is really a guessing game. There is no good model in which you can put in a macroeconomic scenario and accurately forecast how a financial institution is going to perform. That is a fictional story.

The people in charge love it because it played well in 2009 with the stress test. But the fact of the matter is there isn't a stress test anywhere on the globe that ever detected a crisis before it happened or even designated the firms that got into trouble when the crisis happened. There is just so much uncertainty, you can't model it.

And this gives rise to lots of problems when firms go in every year. They spend millions of dollars, hundreds of millions of dollars trying to model it. And their models now are more aimed at modeling how they think the Fed is going to model it rather than what actually happens.

And these are totally fictional, hypothetical scenarios in which their management is forced to put huge effort and huge money on modeling a fictional event that never happens. And if they get a bad grade on that story by the Fed, they can't pay a dividend, they can't buy back a stock, they might not be able to merge with anybody or open up another line of business.

So this is a very judgmental regulatory approach that really isn't based in science at all, and I think it is very destructive.

Mr. TIPTON. So we are modeling for the modeling without an instruction manual?

Mr. KUPIEC. Yes. And we have built a huge industry to support the modeling of the model.

Mr. TIPTON. I believe you are right on that. We just had Secretary Lew before this committee and he refused to answer and give any kind of real information in terms of what information is going to be required for that designation for companies to actually be able to respond to.

I would like to be able to follow up maybe with Dr. Calabria in regards to some of your comments in regards to just the composition under the Federal Reserve Act for designation on the Board. Why is that diversity important?

Mr. CALABRIA. Because I think it is important to keep in mind that different parts of the country move at different paces. Texas is not California. Colorado is not Alabama. And so, I do think if you want a monetary policy that essentially tries to do the best to everybody in the country, you need to have that diversity in the Board.

And I will certainly say as an aside, that the Fed should simply follow the law. The law says no more than two members from one district. It is actually pretty clear. And the fact that that has been flaunted regularly, to me, respect for the law has to start with the regulators or why would the regulated entities think that anything goes themselves.

But, again, the important part is so that you can get a variety of viewpoints so it is not simply Washington or New York that dominates the policymaking.

Mr. TIPTON. And just a final question, for anyone who would like to speak on this; it is a real concern. I think our first obligation is to make sure that the economy of the United States is sound, that our economy is working for our people. And when I hear it is a mystery in regards to the FSOC and its response to the FSB, how concerned should we really be that we are having our policies driven by foreign entities as opposed to charting our own course?

Mr. TAYLOR. You are addressing that generally?

Mr. TIPTON. Yes.

Mr. TAYLOR. One thing I would add to this, is that it is important to discuss and collaborate with other entities what is going on, with other governments, with other regulatory agencies. The Financial Stability Board began as something called the Financial Stability Forum. And I served on that. It basically had an advantage. You had representatives from the treasuries, the finance ministers, the central banks, and from some regulatory agencies, in our case, the SEC. So, those discussions were quite fruitful.

I think there is a concern that actually policy is being made and that commits the United States in some way. So collaboration, if you like, or essentially discussion of what is going on in these groups with the Congress, I think is quite important. But the fact that they exist, I think is not the problem.

Chairman DUFFY. The gentleman's time has expired.

The Chair now recognizes the ranking member of the subcommittee, the gentleman from Texas, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman.

And I thank the witnesses again and apologize for having to step away for a moment.

I would like to go to Ms. Rivlin.

Ms. Rivlin, on page 3 of your testimony you indicate that the campaign to audit the Fed is a misleading misnomer. And I would like for you to elaborate on this if you would. You go on to indicate, to say that it is nonsense, and that the Fed is audited. Would you kindly elaborate?

Ms. RIVLIN. Yes. I think the idea that the Fed is not audited is inherent in the title of the campaign to audit the Fed, and it makes people think maybe they don't have auditors in there the way ordinary financial institutions have to. And that is simply not true. The books of the Fed are carefully audited. They are audited by one of the Big Three, Big Four, whatever, auditing firms and by the GAO.

So it is a misnomer and it is misleading. It is really a bill about second-guessing the Fed on monetary policy, giving authority to write a report about the deliberations on monetary policy. I think that is counterproductive. But in any case, it is not suggested by the title, "Audit the Fed."

Mr. GREEN. Thank you.

Moving to another part of your testimony, you indicate that, in your opinion, the greatest, biggest—and that is the way I am reading it—in your opinion, the greatest, biggest danger to our long-run economic health is political gridlock. Would you elaborate on this, please?

Ms. RIVLIN. I do, and I think particularly the budgetary gridlock. I happen to be one who thinks that we should invest heavily, publicly and privately, in the growth of our economy. That is going to mean infrastructure. It is a scandal if we can't get an infrastructure bill passed when it is bipartisanly supported in the Congress. I believe it means investment in science and investment in skills.

But all of those things cost money and would add to the debt. So we have to pair that set of investments with longer-run control of the rise of entitlements and tax reform that will give us both a fairer, more pro-growth tax systems, and more revenues.

Mr. GREEN. And, finally, on the last page, your last four words are, "Leave well enough alone." Would you care to elaborate? Perhaps you have already covered it, but it might serve us well to hear you explain.

Ms. RIVLIN. I was referring there to the conduct of monetary policy. It is clear, and it has been clear on this panel that there are different views about monetary policy. But I think the Fed is being very transparent about what it is doing and what dilemmas it faces, genuine dilemmas, on what to do next on monetary policy, and I would not interfere with the deliberations on monetary policy. That would be my advice to the Congress.

Mr. GREEN. Thank you very much, Mr. Chairman. I yield back.

Chairman DUFFY. The gentleman yields back.

The Chair now recognizes the gentlelady from Utah, Mrs. Love, for 5 minutes.

Mrs. LOVE. Thank you very much.

Thank you for being here.

Ms. Rivlin, you have spent part of your distinguished career as a Vice Chair of the Federal Reserve Board, so I want to avail myself and the committee of the value of your experience.

As you know, the Federal Reserve has come a long way, I agree with you, in the past 2 decades in improving transparency regarding monetary policy. The three ways that I have seen are: the Federal Open Market Committee publishing its decisions following policy meetings, adding to its statement the votes of individual members; issuing forward-looking guidance; and more recently, the Fed Chair conducting press conferences after every FOMC meeting.

Meanwhile, my biggest concern is that there hasn't been similar progress improving the transparency of the Fed's regulatory policies. In fact, some would argue that the Fed has become more opaque, more secretive with regards to its regulatory policy. Do you agree with that? And if so, how would you explain the Fed's reluctance to achieve similar transparency on the regulation side?

Ms. RIVLIN. I think Dodd-Frank is a work in progress. Everybody is trying to figure out how to make it work. The Fed's primary responsibility is rightly, in my opinion, to focus on systemic risk and how to avoid another 2008 where we did the wrong things for quite a long time and then were suddenly faced with this crisis. But some of the things we have talked about here are judgment calls, how big does an institution have to be to be systemically important?

Mrs. LOVE. Okay. So I can actually identify three major problems with the Fed's lack of transparency regarding its regulatory powers. The first is confusion: Regulatory institutions don't know the

standards by which they are being evaluated. We have heard most recently from small banks regarding the implementation of the Volcker rule, Basel III requirements, and from larger banks with regard to the stress test and recently submitting living wills or plans by which large banks can be dismantled in the event of failure.

The second I have seen is that confusion among the banks can undermine safety and soundness, defeating the whole purpose of regulation in the first place.

And third, a lack of transparency that undermines our ability in Congress to perform our oversight duties. We can't see what is going on. We can't actually offer any thoughts or help on that.

Do you agree with any of those identified problems? And can you tell us if this is something that we can improve upon?

Ms. RIVLIN. I agree with many of the problems. This is part of what I meant by saying Dodd-Frank is a work in progress, that we are trying to figure out how to do it right.

With reference to the discussion that we had earlier about stress tests, there are no perfect stress tests, but they do serve a useful purpose. I think within the financial institution, if they know they are going to have to answer a lot of what-if questions, they are going to worry about it a lot more.

So I think we just have to keep working on those. I am not sure how the Congress can help. That is a very good question. You can keep asking questions. But I think that is about the limit of what you can do.

Mrs. LOVE. I wasn't going to bring this up, but I use things in analogies all the time. I think that is the best way to get a point across. As a parent, I have dealt with sick kids. Whenever they have a fever, we want to make sure that we help out as much as possible, so we would give them a dosage of Tylenol.

There isn't anyone here who would argue that we had a problem that we needed to fix. But sometimes when you give too much of a medicine, you actually end up doing the opposite. In other words, if you give the child too much Tylenol, they can go into a coma.

And there are times where I look and see what we are doing and how much it is actually putting our economy into a coma, what we are doing to actually help the economy. There are times where our regulatory agencies have actually done the opposite in terms of creating banks, creating such large regulatory burdens that we have created big banks, which is what we have tried to avoid in the first place.

So, again, we have to make sure that we have the right type of dose. And that is why Congress is here to help, because it is a balance.

Ms. RIVLIN. I think that is right. And I think in the wake of a huge financial crisis, there is going to be a tendency to overregulate. And that is probably a price worth paying for a while, but we have to be very careful not to overregulate.

Mrs. LOVE. Certainly not at the expense of putting our economy into a downward spiral.

Chairman DUFFY. The gentlelady's time has expired.

Mrs. LOVE. Thank you.

Chairman DUFFY. The Chair now recognizes the gentleman from Texas, the chairman of the full Financial Services Committee, Mr. Hensarling, for 5 minutes.

Chairman HENSARLING. Thank you, Mr. Chairman. And thank you for calling this hearing with this outstanding panel. And I don't often use that phrase.

I am very happy that you all have agreed to testify here. I am sorry more Members, particularly on the Minority side, did not take advantage of the hearing.

Typically, I don't choose to speak at subcommittee hearings, wanting other Members to have their opportunities. But given that there are no other Members in the queue, I just wanted to explore in a little bit more depth the concept of Fed independence vis-a-vis the Fed reform bill that was passed in this committee in the last Congress. And I think the Audit the Fed provision, which has, frankly, been kicking around for several Congresses, was brought up as well.

And I guess I am trying to figure out exactly how asking the Fed, I guess to use your term, Dr. Taylor, to reveal their strategy on top of their goals is somehow interfering with their independence, if they get to set the monetary policy rule convention strategy, if they get to change it, deviate from it; they just have to come and testify in public about it.

Do you have any concerns about that legislative provision somehow interfering with the independence of the Fed in the conduct of monetary policy, separate and apart from every other new responsibility Dodd-Frank has now added to their plate?

Mr. TAYLOR. No, I don't have a concern about that. I think it is, in a sense, my experience in government, it is the other way around. If you have a clearly enunciated set of principles or procedures, then that reduces the chance of giving in to somebody who is asking you to do something special, whether it is outside of government or inside of government. I think it is very, very important.

I think also the history of the ebbs and flows of Fed independence, de facto independence, frequently is related to the Administration, not the Congress. So it seems to me there shouldn't be a concern about independence as that legislation is currently constructed.

Chairman HENSARLING. I think we all know that the Governors on the Board of Governors have 14-year terms, and the Fed has an independent funding stream. So I think, Dr. Rivlin, you used the phrase that the Audit the Fed would simply allow Congress to second-guess monetary policy decisions. I think I heard you say that. I guess I would question then, what is oversight? Does oversight interfere with the Fed's independence? We certainly second-guessed the SEC, CFTC, and the CFPB. It is kind of our job around here in oversight.

So are these particularly overly sensitive, thin-skinned people who serve on the FOMC? Or how does it interfere with their independence if the GAO is able to audit after the fact a monetary policy decision for people who have 14-year terms and an independent funding stream?

Ms. RIVLIN. I haven't actually understood exactly what this Audit the Fed bill wants the GAO to do. It is very obscure. But I think

it is to write a report on what deliberations the Fed went through and how they made monetary policy. And I don't think you learn anything very interesting from that. The Fed doesn't have—

Chairman HENSARLING. But I guess, Dr. Rivlin, the question is, does it interfere with their independence?

Ms. RIVLIN. I think that having another group of people in there writing a report about how these deliberations unfolded and what they did is likely to become quite political, and I think it is unnecessary and not a good idea.

Chairman HENSARLING. I'm sorry. But in the remaining time, Dr. Calabria?

Mr. CALABRIA. I don't see it as interfering with their independence. And certainly we don't see that in terms of GAO audits of the SEC or the CFTC, or these other agencies; they don't sit around and look at every word. As a former Banking Committee staffer, I would certainly say, to me one of the hard parts of the job was to help Members of Congress understand how programs worked. And so one of the real values of GAO is to explain to Congress how government programs work.

Chairman HENSARLING. Quickly, Dr. Kupiec, same subject?

Mr. KUPIEC. No, I can't. I think having to explain your policies to an independent agency who writes a report focuses the mind. So I can't see how it would affect their independence in any way.

Chairman HENSARLING. Quickly, Dr. Taylor, in the time that I no longer have.

Mr. TAYLOR. I guess I have to agree with my two colleagues.

Chairman HENSARLING. Thank you, Mr. Chairman.

Chairman DUFFY. The gentleman yields back.

I would like to thank our witnesses again for your testimony today. This was an informative and enlightening hearing. Thank you.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

Without objection, the hearing is now adjourned.

[Whereupon, at 11:45 a.m., the hearing was adjourned.]

A P P E N D I X

July 14, 2015

Testimony of Mark A. Calabria, Ph.D.
Director, Financial Regulation Studies, Cato Institute
Before the
Subcommittee on Oversight and Investigations
Committee on Financial Services
United States House of Representatives
Hearing entitled “Fed Oversight: Lack of Transparency and Accountability”
July 14, 2015

Mark A. Calabria, Ph.D. is Director of Financial Regulation Studies at the Cato Institute. Before joining Cato in 2009, he spent seven years as a member of the senior professional staff of the U.S. Senate Committee on Banking, Housing and Urban Affairs. In that position, he handled issues related to housing, mortgage finance, monetary policy, economics, banking and insurance. Prior to his service on Capitol Hill, Calabria served as Deputy Assistant Secretary for Regulatory Affairs at the U.S. Department of Housing and Urban Development, and also held a variety of positions at Harvard University's Joint Center for Housing Studies, the National Association of Home Builders and the National Association of Realtors. He has also been a Research Associate with the U.S. Census Bureau's Center for Economic Studies. He holds a doctorate in economics from George Mason University.

<http://www.cato.org/people/mark-calabria>

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Chairman Duffy, Ranking Member Green, and distinguished members of the Subcommittee, I thank you for the invitation to appear at today's important hearing. I am Mark Calabria, Director of Financial Regulation Studies at the Cato Institute, a non-profit, non-partisan public policy research institute located here in Washington, D.C. Before I begin my testimony, I would like to make clear that my comments are solely my own and do not represent any official positions of the Cato Institute. In addition, outside of my interest as a citizen and taxpayer, I have no direct financial interest in the subject matter before the Committee today, nor do I represent any entities that do.

The Federal Reserve and the Financial Crisis

Webster defines accountability to mean “an obligation or willingness to accept responsibility or to account for one's actions.”¹ My fellow panelist, John Taylor, among others has detailed the contribution of monetary policy to the housing boom and bust.² There is little doubt in my mind that expansionary monetary policy contributed to the crisis and is likely to contribute to future crises. In fact I would go as far to say that financial crises almost always contain an element of monetary ease.

In addition to its failings in monetary policy, the Federal Reserve is also directly responsible for a number of regulatory failings that contributed to the crisis, particularly the Federal Reserve Bank of New York. For instance the NY Fed approved the ability of banks to use credit default swaps (CDS) to reduce their regulatory capital.³ This decision was the primary driver behind the growth in AIG's CDS business and the resulting decline in bank capital. Despite Sarbanes-Oxley's attempt to limit the use of off-balance sheet vehicles, the NY Fed also approved of the use of off-balance-sheet special investment vehicles (SIVs) as an avenue for banks to reduce capital while bulking up on mortgage-backed assets. Both these decisions, among others, were direct contributors to the crisis. These decisions also created the environment that encouraged the Federal Reserve rescue of AIG and its creation of a variety of 13-3 assistance programs in order to replace the role of the SIVs which it had previously approved.

¹ <http://www.merriam-webster.com/dictionary/accountability>

² John Taylor, *Getting Off Track*, 2009.

³ See Gillian Tett, *Fool's Gold*, 2010

AIG was quite transparent in its financial filings that the purpose of its CDS business was largely for regulatory “relief”. Nowhere have we witnessed similar admissions by the New York Federal Reserve.

I would submit to the Committee that a number of the Federal Reserve’s actions in 2008 and 2009 were attempts to essentially print money to paper over its mistakes. Not only an unwillingness to accept responsibility for its own failings but an active attempt to cover them up. Such is an example of why countries that do not have their central bank engage in bank regulation appear to have fewer financial crises, less nonperforming loans as a percent of GDP and lower inflation.⁴ The performance of both monetary policy and bank regulation would likely be improved by transferring such responsibilities out of the Federal Reserve.

Also worth noting that being a permanent member of the Federal Open Market Committee (FOMC), the New York Fed bears a higher degree of responsibility for the monetary policies that contributed to the crisis than do other regional reserve banks.

So despite a string of failures, what happen to the New York Fed? Its leadership during those years not only avoiding any accountability, but its President actually received a promotion to Treasury Secretary and led the Administration’s efforts on financial reform. Quite frankly it is hard to think of a more perverse set of incentives.

The Federal Reserve was also the dominate U.S. force behind adoption of the Basel Capital Accords. Had it not been push-back from members of the House and Senate (and FDIC),

⁴ See Barry Eichengreen and Nergiz Dincer. 2011. *Who Should Supervise? The Structure of Bank Supervision and the Performance of the Financial System*. National Bureau of Economic Research <http://www.nber.org/papers/w17401>

the Federal Reserve would have pushed through full adoption of Basel II on U.S. banks. Recall Basel II are the same set of rules that declared Greek sovereign debt to be “risk-free” and the debt of such entities as Fannie Mae and Freddie Mac to be “low risk”. Much of the problems in the European banking system today are a direct result of the adoption of Basel II. Had the views of the Federal Reserve prevailed⁵, the U.S. banking system would have been even more highly leveraged.⁶

“We conclude there was a systemic breakdown in accountability and ethics” –
Financial Crisis Inquiry Commission (FCIC).

Why has there been so little accountability for the Federal Reserve and its failings? One reason is that the Fed has managed to “capture” so many potential sources of oversight. For instance it should not have been surprising that the Financial Crisis Inquiry Commission let the Fed off easily. The staff director of the FCIC was on loan from the Fed after all.⁷ Academia can sometimes serve as a powerful check on institutions. George Mason Professor Larry White has documented how the Fed has essentially captured the study of monetary economics, undermining its potential to hold the Fed accountable.⁸

⁵ <https://www.globalriskregulator.com/Regions/Americas/Newsletter-Dec-2005-Basel-II-trumps-the-US-leverage-ratio-Bies?ct=true>

⁶ Also see: Kevin Dowd, 2011. *Capital Inadequacies: The Dismal Failure of the Basel Regime of Bank Capital Regulation*. <http://www.cato.org/publications/policy-analysis/capital-inadequacies-dismal-failure-basel-regime-bank-capital-regulation>

⁷ <http://www.wsj.com/articles/SB10001424052748703871904575216681057922458>

⁸ http://thestatelessman.com/wp-content/uploads/2013/05/2005-08-white-invest_apparatus.pdf

As the Subcommittee is well aware, the Fed is also exempt from several important Congressional oversight mechanisms. Their funding decisions are outside the appropriations process for instance. Their rule-making is outside the review of the Office of Management and Budget. Nor is Fed rule-making subject to cost/benefit requirements, despite having such a large staff of economists. And is the conduct of monetary policy is outside the review of the Government Accountability Office (GAO).

Professor Joseph Stiglitz has argued that one avenue for accountability for a central bank in a democracy is that the way its "decisions are made should be representative of those that comprise society."⁹ Section 10 of Federal Reserve Act attempts to increase the Fed's representativeness by requiring that "the President shall have due regard to a fair representation of the financial, agricultural, industrial, and commercial interests, and geographical divisions of the country" when making appointments to the Board. Section 10 goes as far as requiring that "not more than one of whom shall be selected from any one Federal Reserve district", prohibiting having the Board dominated by any particular region of the country. Unfortunately these requirements and prohibitions in Section 10 have been blatantly ignored.

The current board has multiple members from the same districts. The current board only has one member from a district west of the Mississippi River – Chair Yellen, and of course she's originally from New York. The most egregious attempt to circumvent these requirements is the claim that when MIT Professor Peter Diamond was nominated to the Fed, that despite having lived pretty much his entire life in Massachusetts, he was actually from Chicago, since he had once given a lecture at Northwestern University. At this rate changing planes at O'Hare will be

⁹ Joseph Stiglitz, 1998. "Central Banking in a Democratic Society." *De Economist*. 146#2: 199-226.

sufficient to make one a resident of Chicago. For the vast majority of American geography, as measured by Federal Reserve District, there is no representation on the Fed's Board.

Nor has Fed appointments lived up to their requirements for "fair representation of the financial, agricultural, industrial, and commercial interests." Yes Wall Street has maintained its representation. And despite their being no requirement for Academia to be represented, academic economists have largely taken over the Board, along with Washington insiders. The Federal Reserve Board was intended to represent a broad cross-section of America, both in terms of geography and economic sectors. It stopped doing so years ago. As a result both its decisions and its legitimacy have suffered.

Since neither the White House or the Federal Reserve appear willing to read the words of Section 10 as they are written, it is up to Congress to clarify the requirements of board membership. Congress would also be wise to place limits on the revolving door between the White House, Treasury and the Federal Reserve. Such has greatly reduced its independence from the executive branch and led to greater politicization of the Federal Reserve.

Dodd-Frank and the Federal Reserve

Despite its failing both before and during the crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act greatly expanded the powers and authorities of the Federal Reserve. Perhaps the most important expansion of Fed responsibilities is the increased role of the Fed in supervising large financial institutions. Section 165 tasks the Fed with overseeing all bank holding companies with \$50 billion or more in assets. This supervision would take the form on more stringent prudential standards, particularly in the areas of liquidity and capital

requirements. The Fed will also have consolidated supervision authority over securities holding companies (SEC registered broker-dealers), as well as supervision of designated financial market utilities engaged in payment, clearing and settlement activities. For the first time non-bank financial infrastructure, such as clearinghouse, will have access to Fed facilities, potentially creating an implied guarantee behind those entities. The Fed will also have supervision of non-banks designated as systemically important by the Financial Stability Oversight Council.

Oddly enough one of the responsibilities which the Fed generally carried out in a balanced and reasonable manner, consumer protection, was the one area where the Fed actually lost authorities. While many of the underlying “consumer protection” statutes were themselves deeply flawed, and often anti-competitive, the Fed usually tried to implement and enforce those rules in a manner informed by economics and consistent with the actual functioning of the markets in question. So far the Consumer Financial Protection Bureau, to where those powers were transferred, has not shown the same sort of reasoned decision-making.

Much has been made of Dodd-Frank’s “restrictions” to the Fed’s 13-3 authorities. Such concerns have been grossly exaggerated. As I have detailed elsewhere,¹⁰ the language of Dodd-Frank and the Fed’s proposed rule do little, if anything, to actually constrain the Fed’s 13-3 powers. All the rescues that so enraged the public in 2008 and 2009 could still be conducted under the Fed’s proposed 13-3 rule.

¹⁰ <http://www.cato.org/publications/commentary/fed-proposal-end-bailouts-falls-short>

Federal Reserve Transparency under Dodd-Frank

The Dodd-Frank Act was not without some modest improvements in transparency, especially in the area of Fed auditing. The primary audit requirements of Dodd-Frank, as they relate to the Fed's actions during the financial crisis, are contained in Section 1109, which directs GAO to:

"...conduct a onetime audit of all loans and other financial assistance provided during the period beginning on December 1, 2007 and ending on the date of enactment of this Act by the Board of Governors or a Federal reserve bank under the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, the Term Asset-Backed Securities Loan Facility, the Primary Dealer Credit Facility, the Commercial Paper Funding Facility, the Term Securities Lending Facility, the Term Auction Facility, Maiden Lane, Maiden Lane II, Maiden Lane III, the agency Mortgage- Backed Securities program, foreign currency liquidity swap lines, and any other program created as a result of section 13(3) of the Federal Reserve Act."

That audit was delivered to Congress in July of 2011. Importantly, the audit required by Dodd-Frank goes beyond a simple accounting of what was lent to whom, but also requires GAO to evaluate the effectiveness and policies of the various lending facilities. As GAO's audit makes clear, the Fed, and in particular the New York Fed, exercised considerable discretion in designing these lending programs and often did so in an extremely ad hoc manner. While it does appear that the Fed made attempts to treat all program participants fairly and equally, a lack of appropriate internal controls within these programs left open considerable potential for abuse.

In addition to the audit requirements of Section 1109, Dodd-Frank also requires under Section 1103(b) that the Fed provide:

“...disclosure in a timely manner consistent with the purposes of this Act of information concerning the borrowers and counterparties participating in emergency credit facilities, discount window lending programs, and open market operations authorized or conducted by the Board or a Federal reserve bank...”

The importance of Section 1103(b) is that participants in future discount window lending will eventually be identified to the public, along with the terms of such lending. Given that Dodd-Frank gives the Fed approximately two years to disclose such information in relation to discount window lending, I believe the risk that such disclosure will dissuade financial institutions from the use of the discount window has been minimized. Of course, if such disclosure encourages financial institutions to manage their operations in such a way to avoid the need for access to the discount window, then the strength of our financial system would likely be improved.

While Sections 1102, 1103 and 1109 of Dodd-Frank are without doubt improvements in Federal Reserve transparency, and some of the few positive provisions in the Act, they fall short of truly bringing the operations of the Fed into the light of day.

Although I believe it to be a grave mistake to continue to entrust the Federal Reserve with bank supervision and regulation, Congress has chosen to maintain, and extend, that situation. The requirements of Section 1108(b) of Dodd-Frank requiring the Fed's Vice Chair for Supervision to regularly appear before Congress should increase transparency and improve Congressional oversight as it relates to the Fed's bank supervision responsibilities.

The non-monetary actions of the Federal Reserve in 2008 and 2009 will likely be debated for decades among economists and historians. Just as the causes of the Great Depression and the effectiveness of the New Deal remain in contention, so will recent actions. What we all can perhaps agree on, or at least hope, is that the extraordinary measures, by Congress, the Federal Reserve and the Treasury, will not be repeated soon or repeated often. Accordingly, much of the audit requirements in Dodd-Frank have something of an “historical” feel to them. However, it is not enough to just get history right, but also to insure that future mistakes are avoided. I can think of few areas requiring as much mistake-avoidance as monetary policy.

Rules versus Discretion: Behavioral Considerations

The basis for discretionary monetary policy, which inherently reduces accountability and transparency, is that the Fed is composed of experts, who know what they are doing. Of course as Stiglitz, no skeptic of technocrats, has recognized the “decisions made by the central bank are not just technical decisions; they involve trades-offs, judgments...”¹¹. While these trade-offs should be made as transparently as possible and reflect the values of all of society, I want to focus on for a moment on the “judgments” part.

As Nobel winning economist and psychologist Daniel Kahneman has observed, experts suffer from all sorts of biases that result in bad decisions and outcomes. Building upon the work of Paul Meehl,¹² Kahneman argues that experts are inferior to simple algorithms (like a Taylor

¹¹ Joseph Stiglitz. 1998. “Central Banking in a Democratic Society.” *De Economist*. 146#2: 199-226.

¹² Paul Meehl, *Clinical vs. Statistical Prediction: A Theoretical Analysis and a Review of the Evidence*.

Rule) because experts “try to be clever, think outside the box, and consider complex combinations of features in making their predictions.”¹³ In the studies reviewed (and sometimes conducted by) Kahneman, experts are always looking for that one additional data point that suggests a different course of action. We see that now with the Fed’s continued claims that its decisions will be “data-dependent” without actually telling us what data it is dependent upon and how that different data will be weighted. Kahneman also notes that experts are inconsistent, giving different answers to the same (or similar) question. This is especially damaging in relying to market participants the direction of monetary policy. Kahneman summarized this research with a “surprising” conclusion: “to maximize predictive accuracy, final decisions should be left to formulas, especially in low-validity environments.”¹⁴

Kahneman, along with psychologist Gary Klein, have investigated which conditions are conducive to relying on the discretion of experts and which are not. It is not surprising that the Fed often characterizes itself as a “firefighter”. Scholars have indeed found that seasoned firefighters have a good intuition about such things as when the floor of a burning building is about to go. Perhaps the most well known popular version of these arguments is found in Malcolm Gladwell’s book *Blink*. The research finds, however, that these expert skills are built up over time. Novice firefighters do not display the same skills as veterans. Such could be one justification for the long terms (14 years) allowed for Fed governors. But most Fed governors do not serve anywhere near that long. As financial crises and turning points in the economy happen

¹³ Daniel Kahneman. 2011. *Thinking, Fast and Slow*. See especially chapters 21 and 22.

¹⁴ Daniel Kahneman. 2011. *Thinking, Fast and Slow*.

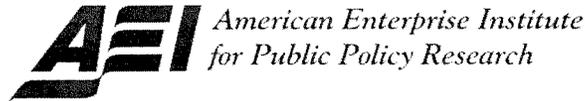
only every few years, close to every 13 years for crises, the fact is that few Fed governors will operate in more than one or two crises.

Monetary policy is also inherently characterized by unpredictability. As Milton Friedman observed, monetary policy operates with “long and variable lags”. Repeatedly various actions by the Fed have promised to produce a specific outcome and failed to do so. The vary complexity and unpredictability of monetary policy suggests such would be more accountable if it were rule-bound.

To summarize the findings, experts can be relied upon when 1) they operate in a regular, predictable environment, and 2) there is an opportunity for learning via repeated practice. Neither of these conditions characterize monetary. Due to the inevitable failings of the Fed, and the groupthink that tends to dominate its operations, further avenues must be found to increase the diversity of input into the Fed’s decision-making.

Conclusions

Chairman Duffy, Ranking Member Green, and distinguished members of the Subcommittee, I thank you holding today’s hearing. The Federal Reserve played a starring role in both creating the financial crisis and in its response. Despite that role and the Fed’s numerous failings, Dodd-Frank largely expanded its responsibilities. Along with our flawed mortgage finance system, our monetary regime remains one of the unaddressed structural flaws behind the crisis. Without reform, including greater accountability and transparency, the Federal Reserve is almost certain to continue its pattern of inflating asset bubbles, in the false hope such will create wealth and jobs. Given the current stance of monetary policy, the need for reform is particularly urgent, if not perhaps a little too late.



Statement for the United States House of Representatives, Committee on Financial
Services, Subcommittee on Oversight and Investigations

Fed Oversight: Lack of Transparency and Accountability

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July 14, 2015

*The views expressed in this testimony are those of the author alone and do not necessarily represent those of the
American Enterprise Institute.*

Fed Oversight: Lack of Transparency and Accountability

Chairman Duffy, Ranking Member Green, and distinguished members of the Subcommittee, thank you for holding today's hearing and for inviting me to testify.

I am a resident scholar at the American Enterprise Institute, but this testimony represents my personal views. My research is focused on banking, regulation, and financial stability. I have included my full resume as an appendix to my testimony, but to summarize my background, I have extensive experience working on banking and financial market policies at the Federal Reserve Board, the International Monetary Fund, the FDIC, and the Bank for International Settlements. It is an honor for me to be able to testify before the subcommittee today.

I will begin by summarizing the main points of my testimony:

- The Federal Reserve (Fed) was created by Congress. Congress retains Fed oversight responsibility and the duty to amend the Federal Reserve Act and related legislation when such amendments are in the national interest. To exercise this duty, the Congress must have the right to assess the Fed's performance and it must have the legal authority to acquire the information that is needed to make such an assessment.
- Numerous court decisions support Congress's investigative authorities. Even in a Supreme Court decision that placed some limits on its investigative powers [*Watkins v United States* 354 U.S. 178], Chief Justice Warren's opinion recognized wide-ranging Congressional investigative powers.
 - o "The power of the Congress to conduct investigations is inherent in the legislative process. That power is broad. It encompasses inquiries concerning the administration of existing laws as well as proposed or possibly needed statutes. It includes surveys of defects in our social, economic or political system for the purpose of enabling the Congress to remedy them. It comprehends probes into departments of the Federal Government to expose corruption, inefficiency or waste."
- The Fed's powers and methods of monetary policy operation have undergone dramatic changes since the financial crisis. Congress would be negligent in its duties if it did not strengthen its oversight of the Fed's monetary policy operations and require the Fed to provide evidence that supports the efficacy and economic benefits of its new operating policies. Significant changes in Fed monetary policy operations that merit deeper Congressional investigation include:
 - o The FOMC's redefinition of the Fed's "price stability mandate" to mean an annual expected core inflation rate of 2 percent:¹

¹ See, Narayana Kocherlakota, "Clarifying the Meaning of Price Stability," <https://www.minneapolisfed.org/authors/narayana-kocherlakota>

- o The practice of continuously re-defining the Fed's target rate of unemployment that is consistent with "maximum employment" and price stability;
 - o Evidence that a continuation of its zero-interest rate policy promotes economic growth without creating conditions that lead to serious financial instabilities; and,
 - o Credible assurances that the Fed's dual mandate of price stability and maximum employment will not be sacrificed to international pressures to offset financial market panics in Europe, Asia, or elsewhere.
- Should Congress decide to use the Government Accountability Office (GAO) to help it assess the Fed's monetary policy performance, it must pass new legislation. To the best of my knowledge, at present, there are no legal barriers that prevent Congress from assessing Fed monetary policy without the use of the GAO.²
 - Many regulatory initiatives related to the Fed's Dodd-Frank expanded powers merit closer Congressional oversight including:
 - o The Fed' ongoing interactions with international standard-setting bodies including the Financial Stability Board, the International Association of Insurance Supervisors, and the Basel Committee on Banking Supervision;
 - o The implementation of the Fed's [Board of Governors] stress tests mandated by Section 165 of the Dodd-Frank Act; and,
 - o Conflicts that may be developing between the Fed's expanded powers over the domestic insurance industry and state insurance regulations.
 - The Fed is the most opaque of the "independent" Federal financial regulatory agencies. It sets its own accounting standards that are inconsistent with generally accepted accounting practices for financial institutions and it routinely acts as if its independence on monetary policy matters shields it from disclosing information on its operations including staff salaries, benefits, hiring practices and Congressional inquiries regarding internal investigations.³ Congress must mandate greater transparency.

New Federal Reserve Powers & Behavior Create Demands to "Audit the Fed"

The Fed was created by Congress in 1913 with limited responsibilities. These included: the establishment of regional Federal Reserve banks; the provision of an elastic currency; the rediscounting of commercial paper; and, the supervision of Federal Reserve member banks. Over the years Congress amended the Federal Reserve Act to liberalize constraints on Fed operations, establish a Federal Reserve Open Market Committee, change the Fed's governance structure, require periodic reports by the Fed Chairman to Congress, and assign the Fed specific monetary policy goals.

² The Federal Banking Agency Audit Act of 1978 explicitly restricts the GAO from evaluating Fed activities related to the Fed's monetary policy functions. No new legislation is required for GAO assessments of other Fed activities and process including the expanded regulatory powers granted to the Fed and the Board of Governors by the Dodd-Frank Act.

³ See Da Costa, "Yellen: Fed Was Advised Against Fully Complying With Subpoena on Leak Probe," *Wall Street Journal*, June 5, 2015.

For most of its history, the Fed's battle for independence has been a struggle to formulate monetary policy without interference from the executive branch. Before the Fed won its independence from the U.S. Treasury in the early 1950s, many administrations had run the Fed as if it were a subsidiary of the U.S. Treasury.

Today the battle for Fed independence is a struggle to maintain minimal Congressional oversight over its monetary policy and regulatory activities, and a fight to maintain the legal luxury to carefully manage the Fed's operational transparency. The current struggle is probably less about safeguarding monetary policy from being high-jacked by parochial Congressional interests, but more about safeguarding unique Federal Reserve privacy privileges derived from its monetary policy functions.

Critics of "audit the Fed" proposals argue that the modern Federal Reserve is already transparent regarding its monetary policy deliberations and operations. True, the Fed now releases minutes and transcripts from its FOMC meetings with delay, and it has websites that document the details of its balance sheet and securities holdings. The Dodd-Frank Act pushed the Fed to disclose details about borrowers using the Fed's emergency credit facilities⁴ and, beginning in 2012, the Fed was required to release detailed data on discount window borrowing⁵ and open market transactions⁶ with a two-year lag.

While the Fed has become more transparent in recent years, the changes have occurred only after extreme legal and public pressure. There has been no sea-change in the Fed's willingness to disclose information that is in the interest of the Congress and the general public if this information might also be damaging to the Federal Reserve's reputation. For example, the Fed's recent decision to ignore a Congressional subpoena from this very Subcommittee for information pertaining to the Fed's internal investigations into a 2012 leak of confidential FOMC information is a clear and appalling example of the Fed's continued belief that its "independence" will ultimately shield it from Congressional oversight.

Moreover, disclosure is not the same thing as oversight. Oversight involves independent evaluation of process and performance,⁷ and Congress—by virtue of its power to create the Fed and alter the laws that govern the Fed's operations—has the responsibility for Fed oversight.

In carrying out its many oversight functions, Congress often requests that the GAO undertake an independent assessment and report to Congress. The Federal Banking Agency Audit Act of 1978 gives the GAO audit authority over the Federal Reserve, but it prohibits the GAO from auditing the Fed regarding:⁸

- Transactions with or for foreign central banks, governments, or non-private international financing organizations;
- Deliberations or actions concerning monetary policy;

⁴ http://www.federalreserve.gov/newsevents/reform_transaction.htm

⁵ http://www.federalreserve.gov/newsevents/reform_discount_window.htm

⁶ http://www.newyorkfed.org/markets/OVIO_transaction_data.html

⁷ For further discussion, see Marc Labonte, "Federal Reserve: Oversight and Disclosure," Congressional Research Service, September 19, 2014.

⁸ 31 U.S. Code Sec. 714. The GAO normally has a number of separate Federal Reserve audits underway in any single year. The Federal Reserve System also has an Office of Inspector General (OIG) that is responsible for detecting and preventing fraud, waste and abuse. The Fed's OIG also issues semiannual reports to Congress.

- Federal Open Market Committee transactions; and,
- Discussions and communications between Federal Reserve members, officers or employees associated with the prior three areas.

Given the uncertainties associated with the long-run economic impacts of the Fed's post-crisis monetary policy, it is not surprising that many seek expanded Congressional oversight over the Fed's monetary policy process. For example, among other legislative features, S.264 (the Federal Reserve Transparency Act of 2015) would remove all restrictions on the GAO's ability to audit the Federal Reserve. An alternative proposal, H.R. 5018 (the Federal Reserve Accountability and Transparency Act of 2014) would remove all GAO audit restrictions and also require the Fed to provide the Congress with detailed information regarding its monetary policy decision rule.

While S.264 and H.R. 5018 would improve Congress's ability to evaluate the Fed's monetary policy operations using the GAO, I do **not** favor open-ended Congressional remits asking the GAO to assess Fed monetary policy. Unless GAO studies are carefully targeted, they rarely produce definitive conclusions.

If the Congress decides to use the GAO, it should employ the agency in a targeted way using very prescriptive terms of reference that are designed to provide appropriate Congressional committees specific information that will allow Congress to assess the Fed's monetary policy performance.

Congress, for example, could ask the GAO to provide an independent assessment of the historical accuracy of the Fed's policy forecasts used by the FOMC. Did the economy respond to the Fed's policy in the way the FOMC anticipated? Or the Congress might ask the GAO to construct a mark-to-market balance sheet for the Fed so Congress can assesses the true consequences of the Fed's "Quantitative Easing" policy actions. This will be especially important once long-term interest rates rise and the Fed experiences unrecognized mark-to-market losses on its huge long-term bond portfolio.

The modern Fed does far more than monetary policy, and the Fed's non-monetary policy duties also raise important accountability concerns. The Dodd-Frank Act (the Act) grants the Fed extensive new powers to formulate supervision, regulation, and bankruptcy reorganization standards for large financial institutions, and yet the Act itself includes no explicit congressional control over these expanded Fed powers. Indeed recent speeches by Fed officials argue that the new Fed "macroprudential powers" are an essential complement to monetary policy, especially in the current zero interest rate environment.

Using its expanded regulatory powers, the Fed has the ability to shape the growth and development of the entire U.S. financial system. Unless the Congress exercises heightened oversight and control over the Fed's use of these expanded regulatory powers, Congress will delegate decisions that determine the future vitality of U.S. financial markets to unelected Fed officials who are at best only weakly accountable to the public.⁹

⁹ The Federal Reserve chairman and vice-chairman face Senate confirmation every 4 years. Federal Reserve governors are confirmed by the Senate, but limited to a 14-year term unless they are initially filling a partial term of departing governor. Regional Federal Reserve bank presidents are not confirmed by the Senate.

In subsequent sections, I focus on the need for expanded congressional oversight over the Fed's Dodd-Frank regulatory powers and related operations. Current legal authorities appear adequate and do not appear to restrict Congress ability to audit the Fed's regulatory activities (including use of the GAO).¹⁰

No Oversight of the Fed's Relationship with International Standard Setting Bodies

A recent GAO report¹¹ examined the relationship between Financial Stability Oversight Council (FSOC) designations of nonbank financial firms for enhanced supervision and regulation by the Federal Reserve Board (FRB) and prior designations of the same firms (as global systemically important institutions) by the Financial Stability Board (FSB). Since the Treasury and FRB are both members of the FSB designation group, this coincidence raised concern that the FSOC designation decisions were actually made during FSB deliberations, well before the FSOC completed its designation analysis.

The GAO reported that Treasury and FRB officials it interviewed argued that FSB designations imposed no constraint on the FSOC's subsequent designations, but were just "another factor" taken into account in the FSOC deliberations. The GAO report also includes commentary and footnotes that suggest that GAO investigators had a difficult time believing these claims. The GAO noted that FSB documents report that national authorities are fully consulted before the FSB publically designates individual institutions.

A recent letter to G20 Ministers and Central Bank Governors dated February 4, 2015¹² is especially informative on this issue. In this letter, FSB chairman (and governor of the Bank of England) Carney, makes clear to FSB members that the decisions of the FSB are *directives*, which all FSB members are expected to carry out. In this letter, chairman Carney states specifically that FSB members—including the FRB— have agreed to "Full, consistent and prompt implementation of agreed reforms."

FSB chairman Carney's letter notes that "FSB peer reviews" will cover "implementation of the G20 policy framework." Chairman Carney reinforces the point mentioning that the FSB's will use its oversight as a means for achieving its objectives: "The FSB will support the determined efforts of its members through enhanced monitoring of implementation and its effects across all jurisdictions. We will regularly report our key findings to the G20."

The only reasonable interpretation of chairman Carney's letter is that the FRB agreed that US financial regulatory policies and institution designations will be guided by FSB directives. Moreover, the FRB has agreed that its policy implementation can be overseen by a body

¹⁰ If however, there are legal impediments for GAO audits of which I am unaware, simple amendments to the Dodd-Frank Act, like extending Section 122 powers to other sections of the Act, could explicitly provide the needed powers.

¹¹ Report to the Ranking Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, "Financial Stability Oversight Council: Further Actions Could Improve the Nonbank Designation Process," GAO, November 2014.

¹² <http://www.financialstabilityboard.org/wp-content/uploads/FSB-Chair-letter-to-G20-February-2015.pdf>

dominated by European bureaucrats and chaired by the governor of the Bank of England.¹³ While the US Treasury was clearly aware of these developments by virtue of their own FSB membership and participation, it does not appear that the US Congress received prior consultation before the FRB and the Treasury made these commitments.

Recent experience raises legitimate concerns that the FRB and the Treasury have been deciding on FSOC designations well before the FSOC finalizes its analysis. Given the unbalanced nature of FSOC member resources, pressure from the Treasury and the FRB on other FSOC members would likely be more than adequate to ensure a specific institution's designation. The November 14 GAO report documents that FRB has by far the largest staff allocated to the FSOC designations process and it is unlikely that few if any of the other FSOC members without a direct regulatory interest would challenge the FRB staff on its designation conclusions.¹⁴ Indeed Federal Reserve influence on FSOC designations goes beyond the FRB as there are reports that Federal Reserve Bank of New York staff has also been heavily involved and influential in the FSOC designation process.¹⁵

The recent FSOC decision regarding MetLife's designation for heightened prudential standards and supervision by the FRB highlights the overwhelming influence that the FRB and Treasury can have on the FSOC designation process, especially when the FSOC's members have no direct interest in the non-bank industry under consideration. Dissenting from the FSOC's MetLife designation was the council's independent member having insurance expertise and the Council's state insurance commissioner representative.¹⁶ Moreover, the state insurance commissioners from five states—California, Connecticut, Delaware, New York and North Carolina— independently wrote to FSOC Chairman Lew to protest the MetLife designation.

The MetLife dissent opinion written by the FSOC's independent member with insurance expertise was particularly informative about the relationship between FSB designation and subsequent FSOC decisions. It is worth quoting at length:

On July 18, 2013, the Financial Stability Board (FSB), an international organization within the umbrella of the Group of Twenty (G-20), primarily comprising the world's finance ministers and central bankers, including the U.S. Department of the Treasury (Treasury) and the Board of Governors, announced that it had identified MetLife as a global systemically important financial institution (G-SIFI). G-SIFIs are declared by the FSB to be "institutions of such size, market importance, and global interconnectedness

¹³ If the Fed can agree to let European bureaucrats have oversight over the implementation of its regulatory policies, it is outrageous for the Fed to argue that its monetary policy implementation should be protected against additional Congressional scrutiny.

¹⁴ No other agency has a staff as large, technically sophisticated, or as academically credentialed as the Federal Reserve. For example, the FRB has more than 350 economists on its home webpage, <http://www.federalreserve.gov/econresdata/theeconomists.htm> and virtually all of them have PhDs. This does not include Federal Reserve economists at the Reserve Banks. For example, the New York Fed alone lists 71 PhD economists on its website. In contrast, on their respective websites, the CFTC lists 10 economists, the FDIC lists 19 economists, FHFA lists 15 PhD equivalent economists, and the newly "economist fortified" SEC lists roughly 70 economists.

¹⁵ See the letter dated July 9, 2014, from Representative Garrett to William Dudley expressing concerns and additional information about the New York Fed's extensive involvement on the FSOC designation process.

¹⁶ <http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf>

that their distress or failure would cause significant dislocation in the global financial system and adverse economic consequences across a range of countries.” Thus, MetLife was declared by the FSB as a threat not to just the U.S. financial system, but to the entire global financial system.

The FSB’s announcement of the identification of MetLife and eight other insurers as G-SIFIs stated that its action had been taken “in collaboration with the standard-setters and national authorities;” and, that as G-SIFIs, these organizations would be subject to policy measures including immediate enhanced group-wide supervision, as well as to recovery and resolution planning requirements. It is clear to me that the consent and agreement by some of the Council’s members at the FSB to identify MetLife a G-SIFI, along with their commitment to use their best efforts to regulate said companies accordingly, sent a strong signal early-on of a predisposition as to the status of MetLife in the U.S -- ahead of the Council’s own decision by all of its members.

Despite subsequent assertions by some of the Council’s members that the FSB and Council processes are separate and distinct, they are in my mind very much interconnected and not dissimilar. It would seem to follow that FSB members who consent to the FSB’s identification of G-SIFIs also commit to impose consolidated supervision, yet-to-be agreed-to capital standards, resolution planning, and other heightened prudential measures on those G-SIFIs that are domiciled in their jurisdictions.

These pointed remarks from FSOC members make it apparent that that the Congress must exercise closer oversight over the Fed’s participation in FSB work streams. For example, H.R. 5018 would require the Fed to notify congressional committees with jurisdiction and the general public 90 days prior to its intention to enter into or complete negotiations with international committees or standard setting bodies.

Regardless of the method the Congress selects, it needs to improve oversight of the Fed’s involvement in FSB initiatives, especially those regarding the capital regulation of insurance firms including any work streams on capital surcharges for insurance firms designated as global systemically important institutions as well as Fed involvement in FSB work streams focused on the designation of systemically important non-bank non-insurance (aka shadow bank) institutions and the enhanced regulation of “shadow banking” activities.¹⁷

When Fed officials refer to shadow banking, they are referring to activities that primarily associated with the asset management industry. In January 2014, the FSB issued a consultative document discussing a designation process for non-bank non-insurer systemically important firms.¹⁸ Firms fitting the FSB’s consultative document profile are large asset management institutions. In November 2014, the FSB committed to issue policy recommendations that will establish regulatory minimum “haircuts” for securities financing transactions (securities lending and repurchase agreements) among shadow banks. Mirroring these developments, senior Fed officials used recent speeches to telegraph the Fed’s intention to impose market-wide minimum haircuts on securities lending and repurchase transactions. Fed officials have also identified high-

¹⁷ http://www.financialstabilityboard.org/wp-content/uploads/r_130829c.pdf

¹⁸ http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf?page_moved=1

yield short-maturity by mutual fund investments as a shadow banking activity that should be discouraged as a potential source systemic risk.

The FSB is also in the process of recommending changes in insurance regulation. In October 2013, the FSB directed the International Association of Insurance Supervisors to develop a comprehensive supervisory and regulatory framework, including a risk-based global insurance capital standard for internationally active insurers as well as basic capital requirements and higher loss absorbency requirements for global systemically important insurance institutions. The FRB is an important member of this FSB insurance work stream and many observers believe that the Fed will eventually try to impose the FSB's insurance regulatory capital standards on state-regulated domestic U.S. insurers. The potential conflict with FSB insurance capital initiatives and U.S. insurance company capital requirements will be discussed in a subsequent section of my testimony.

If recent history is a guide, the policies the Fed develops in these and any other FSB work streams will form the basis of the policies the Fed subsequently attempts to impose as domestic regulations. It is important for Congress to step up its oversight of the Fed's involvement in FSB activities so it can make a timely evaluation of regulatory developments. Once FSB work streams conclude, it becomes more difficult for Congress to intervene and alter US financial regulatory policies.

Who Assesses the Assessor? Congress Must Revisit Section 165 FRB Stress Tests

Section 165 of the Dodd-Frank Act directs the FRB to establish heightened prudential standards that apply to bank holding companies with consolidated assets in excess of \$50 billion and non-bank financial firms designated by the FSOC. Included in Section 165 is the requirement that these institutions participate in an annual stress test exercise supervised by the FRB which is required to publish the results of these annual stress tests. In addition, financial institutions with \$10 billion in consolidated assets and a primary Federal regulator must conduct annual stress tests similar to the FRB stress test and report the results to their primary Federal regulator.

Congress should consider an extensive audit of the Dodd-Frank mandate for recurring FRB stress tests. The audit should include an independent assessment of the FRB's stress test models and methodology including an assessment of the predictive accuracy (i.e. stress test model prediction confidence bounds) of the Fed's methodology. Assessments should evaluate the consistency with which the FRB applies its quantitative and qualitative stress test assessments both across institutions within a year and the Fed's consistency across time. Independent assessors should identify weaknesses in the methodology and evaluate the FRB's internal approach for identifying and managing stress test methodology weaknesses. The examination should include the remediation process that occurs when a bank disputes the Fed's findings. Assessors should have confidential discussions with the financial institutions that have participated in these stress test exercises and report on these institution's concerns with the Fed's processes. The audit should evaluate the costs and benefits of using this methodology as a primary input in supervision and regulation of individual institutions.

Better yet, Congress should just repeal the Dodd-Frank requirement for annual Section 165 FRB stress test.

The FRB stress tests mandated by Dodd-Frank Act are expensive both for the banks and bank regulatory agencies and these resources could be deployed in other productive activities. These stress tests have dubious predictive power for identifying hidden financial system imbalances or for identifying risks in specific financial institutions that would otherwise remain undetected. The quantitative outcome of these stress tests is arbitrary and completely under the control of the FRB because the stress tests estimates involve an overwhelming amount of judgment on the part of the stress tester. Consequently stress test results cannot be replicated by different independent stress testers. Since banks cannot accurately anticipate the FRB stress test results even when they know the macroeconomic stress scenarios, this mandatory process interjects a costly and unproductive source of uncertainty in the bank planning process.

FRB stress tests are a particularly problematic form of enhanced prudential supervision because there is no objectively correct answer in a FRB stress test. Participants are required to produce specific numerical answers to hypothetical questions that have no single correct answer with full knowledge that the FRB has wide discretion to decide the "correct answer" at will by changing modeling assumptions. Moreover, institutions have no mechanism to challenge the FRB on the accuracy of Board's preferred correct answer.¹⁹

Many have questioned the value of macroeconomic scenario stress tests for identifying and mitigating financial sector excesses²⁰ and yet the Fed spends an enormous amount of resources and requires covered institutions to spend significant sums on the activity. Already, Fed stress tests have missed the "London Whale" at JPM Chase and a multibillion dollar hole in Bank of America's balance sheet. Fannie Mae and Freddie Mac both passed government-designed macroeconomic stress right up to the time they failed in September 2008. Before the financial crisis, many countries produced financial stability reports that included bank stress tests and none anticipated the crisis. And there are many additional examples where similar tests failed to identify subsequent problems.

A stress-test based approach for setting bank capital has two gigantic measurement problems. First, the macroeconomic scenario must actually anticipate the next financial crisis. And secondly, regulators must be able to translate the macroeconomic crisis scenario into accurate predictions about actual bank profits and losses.

Few regulators possess the prescience necessary to accomplish this first step. Indeed, after decades of trying, the Fed has yet to develop models that can accurately forecast aggregate

¹⁹ See Kevin Dowd's discussion in, "Math Gone Mad: Regulatory Risk Modeling by the Federal Reserve," CATO Policy Analysis No. 754, September 3, 2014.

²⁰ For some examples, see: C. Borio, M. Drehmann, and K. Tsatsaronis, "Stress-testing macro stress testing: Does it live up to expectations?" Bank for International Settlements, November 2011; or, Til Schuermann, "The Fed's Stress Tests Add Risk to the Financial System," *Wall Street Journal*, March 19, 2013; or, L. Guerrieri and M. Welch, "Can Macro Variables Used in Stress Testing Forecast the Performance of Banks?" Federal Reserve Board Finance and Economics Discussion Series 2012-49.

economic activity in the near term—the Fed’s main job.²¹ Why then would anyone expect the Fed to accurately anticipate the next financial crisis?

Even if a stress scenario correctly anticipates a coming crisis, the crisis must be translated into individual bank profits and losses. However, bank profits and losses are not very tightly linked with changes in macroeconomic indicators. Quarter-to-quarter bank profits do not closely follow quarterly changes in GDP, inflation, unemployment, or any other macroeconomic indication. The best macroeconomic stress test models explain maybe 25 percent of the quarterly variation in individual bank profits and losses, meaning that more than 75 percent of the variation in bank profit and losses cannot be predicted using econometric models and projections of GDP, unemployment, or other business cycle indicators.

Because of these measurement issues, bank loss predictions from macroeconomic stress tests have very little objective accuracy. Even the best model estimates have wide range of prediction error uncertainty surrounding forecasts of how each bank may actually perform in the next crisis, presuming the stress scenario anticipates the crisis.

These issues make macroeconomic stress testing more of an art than a science and a tool that is inappropriate for the supervision on an individual institution. There are just too many places to make mistakes. There is no formula or procedure that will lead to a single set of stress test bank loss estimates that can be independently calculated by different stress test modelers. Thus, it is not surprising that the Board of Governors and the US banks rarely agree on stress test results.

Less widely appreciated is that these coordinated macroeconomic stress tests encourage a “group think” approach to risk management that may actually increase the probability of a financial crisis.²² Stress test crisis scenarios have to be specific so that banks and regulators can model the same event. Moreover, the FRB imposes some uniformity in loss rates across all designated banks by using its own stress test estimates. Perhaps unintentionally, by requiring all firms to approach the stress test problem in the same way as the FRB, the process encourages all large institutions to think and operate the same way.

A final weakness concern is that the stress test process requires the FRB to be intimately involved in modeling the operations and exposures of each large banking institution. The process requires the FRB to use its own judgment to set each large bank holding company’s “stress tested” capital plan. These regulations have become so intrusive that the regulator virtually runs the bank. In such a situation, it becomes difficult for the regulator to admit a mistake and allow an institution to fail.

Congress Should Step in Before the Fed Becomes the National Insurance Regulator

The new regulatory powers granted by the Dodd-Frank Act to the Fed could lead to substantial changes in insurance regulation. Since the McCarran-Ferguson Act of 1945, insurance regulation has been conducted by the states and their insurance commissions. The Dodd-Frank Act created

²¹ For example, see Lansing and Pyle (2015), “Persistent Over optimism About Economic Growth,” *FRBSF Economic Letter* (Feb 2).

²² Til Schuermann, *op. cit.* makes this argument.

a new Federal Insurance Office within the US Treasury, but the Act purposely limited the new office's responsibilities to monitoring and advisory duties; it does not have national supervisory responsibility.

Notwithstanding the fact that the Dodd-Frank Act intentionally avoided the creation of a national insurance regulator, many in the insurance industry believe that the Fed is using its new Dodd-Frank powers to become the *de facto* national insurance supervisor. These developments could lead to wholesale revisions in the supervision and capital regulations that apply to state insurers and result in the imposition of bank-style capital regulation on the insurance industry.

Section 312 of the Dodd-Frank Act transferred regulatory authority and rulemaking over thrift holding companies and insurance holding companies that owned depository institutions from the Office of Thrift Supervision to the Fed. Section 604 of the Act authorizes the Fed to conduct examinations of the non-bank subsidiaries and affiliates of these holding companies even if these institutions have a functional regulator.

Section 312 empowers the Fed to examine insurance companies whereas, prior to the Dodd-Frank Act, bank regulators were prohibited from examining these state-regulated entities. Since acquiring its new powers, the Fed has launched an extensive examinations program for insurance companies owned by thrift and insurance holding companies. These examinations often are conducted using newly hired Fed examiners with little or no insurance experience, even though these insurers being examined are already fully regulated and supervised by state insurance commissioners.^{23, 24}

These Fed insurance examinations are causing considerable concern for insurers. Industry sources suggest that the Fed examiners are less than fully conversant with state insurance regulations and they frequently find that insurer subsidiaries or affiliates are undercapitalized if their capital levels do not agree with bank capital standards, even when these insurers are well-capitalized according to long-standing state insurance regulations. Representatives of the insurance industry are worried that, unless Congress intervenes, these Fed insurance examinations and associated holding company regulatory capital restrictions will eventually lead to the imposition of bank regulatory capital standards on the entire insurance industry.

Section 606 of the Dodd-Frank Act allows the Fed to apply its bank holding company "source of strength doctrine" to the insurance and thrift holding companies which it now regulates. Industry sources suggest that the Fed's erroneous examiner opinions alleging weak capital positions at insurance subsidiaries and affiliates have led the Fed to conclude that the consolidated capital positions of some holding companies must increase. Again, in the opinion of the insurance industry experts familiar with the specific details of these cases, these mandated capital increases are not addressing true holding company capital weaknesses. Instead they are the result of longstanding and appropriate differences between the capital regulations for insurers (set by the

²³ Testimony of Thomas Sullivan of the Board of Governors before the House Subcommittee on Housing and Insurance, November 18, 2014.

²⁴ For official Federal Reserve guidance on these examinations, see <http://www.federalreserve.gov/bankinfo/reg/srletters/sr1111a2.pdf>

states), and consolidated capital standards for banks (set by the US bank regulatory agencies in consultation with the Basel Committee on Bank Supervision).

Industry representatives suggest that the Fed's approach for assessing the capital position of thrift and insurance holding companies could lead to new insurance industry constraints on dividend payments or other transactions that return capital to shareholders. The Fed can apply its holding company capital rules even in cases where the holding company is comprised predominately of insurance related activities and includes a subsidiary depository institution that holds only a tiny fraction of the holding companies' assets.²⁵ Recent congressional testimony by FRB Senior Advisor Thomas Sullivan did not allay industry concerns when he reported, "Our principal supervisory objectives for insurance holding companies are protecting the safety and soundness of the consolidated firms and their subsidiary depository institutions..."²⁶

With the Fed's acquisition of thrift and insurance holding company supervision and the three large FSOC-designated insurance companies now subject to enhanced supervision and regulation by the Federal Reserve Board, the Federal Reserve is now the consolidated supervisor of companies that hold about one-third of the asset in US insurance industry.²⁷

Reflecting these new insurance powers, in 2013 the Fed joined the International Association of Insurance Supervisors—the international standard setting body for insurance regulation. The Fed is now a member of the IAIS work stream that is developing global standards for the supervision and regulation internationally active insurers, including regulatory capital standards for insurance groups.²⁸ This work is part of the overall G20 financial stability initiative coordinated by the FSB. The Fed is also a member of the IAIS group that is responsible for identifying global systemically important insurers and designing the enhanced regulatory and supervisory framework that will apply to these institutions.

The Fed is a member of the IAIS work stream charged with developing group-wide capital standards for insurance groups. These consolidated capital requirements are similar to the consolidated capital requirements for bank holding companies. For some years, Europe has been developing new insurance capital standards called Solvency II. Solvency II standards are in many respects similar to the Basel capital standards for banks and bank holding companies. In fact, Solvency II is often called "Basel for insurers." The similarity between bank and insurance capital requirements in Europe is no accident because European insurance activities are often conducted as part of a universal banking organization. Because the IAIS membership is dominated by European insurance supervisors, many believe that, in the end, any new IAIS group-wide standard will strongly resemble Solvency II.

²⁵ For a detailed discussion of the issues that concern the industry see, *Letter to regulatory agencies on behalf of Nationwide Mutual Company regarding 'Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action.* http://www.federalreserve.gov/SECRS/2012/December/20121206/R-1442/R-1442_101712_109102_441597364672_1.pdf

²⁶ See Thomas Sullivan's testimony.

²⁷ *Ibid.*

²⁸ *Ibid.*

In contrast to Europe, the United States does not have a consolidated capital standard for insurers. Historically, the U.S. approach to insurer capitalization has served the industry well. It has not resulted in any systemic weaknesses and it likely works to contain contagion risk because it limits interdependencies among insurance companies. US capital standards are set for individual state insurance entities that are incorporated and fully capitalized within a single state. They are licensed, regulated and if need be, liquidated at by the state insurance regulator. Consolidated group capital has not been an important issue in the United States because each state chartered insurance entity must be fully capitalized and cannot rely on capital support from a larger insurance group.

The extent of the Fed's involvement in insurance regulation and the potential for the Fed to impose significant changes on insurance supervision and regulation was unlikely to have been anticipated by Congress. The Fed is now poised to become the *de facto* national insurance regulator that Congress declined to create in the Dodd-Frank Act. The Fed is empowered to exam firms that hold one-third of insurance industry assets even though these firms are examined by state insurance regulators. The Fed is now also the most influential US regulatory member charged with designing new capital and supervisory processes in the IAIS/FSB work stream. The Fed is already showing a preference to impose bank capital regulations on insurance holding companies and there is industry concern that the Fed may agree to Solvency II bank-like capital regulations in its IAIS insurance capital work stream.

Improving the Transparency of Other Federal Reserve Operations

Over time, the Fed has stretched the interpretation of its monetary policy "independence" to reduce its transparency on many other operating issues that it prefers not to publically disclose. For example, the Fed decides on its own accounting standards, and it has decided that it will never recognize that Fed operating losses could render the Fed insolvent (i.e. negative capital) if its accounting followed generally accepted accounting standards.²⁹

When long-term interest rates begin to rise, the Fed will suffer massive mark-to-market losses on its bond portfolio holdings, and yet the Fed has decide it will not recognize these losses on its financial statements. When the Fed increases short-term interest rates, it will do so by raising the rate it pays banks on their reserves held in Federal Reserve banks. Depending on the level of rates, this will reduce the 'net' income the Fed returns to the Treasury by tens of billions of dollars and indeed it is possible that, should rates revert to "normal long-run levels" the Fed could payout more on reserves than it earns in interest on its bond portfolio.³⁰ In this case, the Fed would not remit anything to the US Treasury, and would have negative cash flow—cash payouts that exceed cash inflows— but the Fed would not record the loss as a reduction in its capital position. In other words, the Fed's accounting system will never show the Fed to be insolvent, no matter how insolvent it the Fed may be when measured by generally accepted accounting standards. According to the FRB,³¹

²⁹ See for example, Alex Pollack, "The Central Bank of Switzerland announces a huge loss: Would the Fed ever be this honest?" <https://www.aei.org/publication/the-central-bank-of-switzerland-announces-a-huge-loss-would-the-fed-ever-be-this-honest/>

³⁰ See Paul Kupiec, "Why Taxpayers will be on the hook when it's time to raise rates," *American Banker*, August 27, 2014.

³¹ S. Carpenter, J. Ihrig, E. Klee, D. Quinn, and A. Boote, "The Federal Reserve's Balance Sheet and Earnings: A primer and projections," Federal Reserve Board, *Finance and Economics Discussion Series: 2013-01*

“Dividends are paid even if remittances to the Treasury would be zero. As discussed earlier, in the event that earnings fall short of the amount necessary to cover operating costs, pay dividends, and equate surplus to capital paid-in, the Federal Reserve books a liability of “interest on Federal Reserve notes due to U.S. Treasury.” This line item is recorded in lieu of reducing the Reserve Bank's surplus, and represents the amount of earnings the Federal Reserve needs to accumulate before it resumes remitting residual earnings to U.S. Treasury.”

The lack of Fed transparency extends to areas beyond its accounting statements. Unlike other Federal Government agencies, the Fed refuses to comply with Freedom of Information Act requests on personal salaries and bonus.³² Federal Reserve district banks apparently argue that they are not part of the Federal government, and so their employee salary information is exempt from FOIA requests. I am unsure how the FRB avoids complying with FOIA requests for salary information but, to the best of my knowledge, no request has been successful in acquiring a complete list of the FRB staff and their salary and bonuses. In contrast, financial regulatory agencies routinely comply with such requests.

Federal Reserve hiring practices also differ markedly from other government agencies in ways that I doubt the public (and perhaps the Congress) is aware of. Before a “normal” federal government agency could even entertain the possibility of hiring a foreign national for a permanent staff position, the agency must seek (and be granted) special permission from the US Office of Personal Management. To gain permission, the agency must establish that it has a requirement for special skills that cannot be met by US citizens, and it must document the shortage of US citizens with the needed skill. Of the few agencies who gain this approval from OPM, I am not aware that any agency pays for the legal fees the new hire must spend to acquire permits needed to work legally in the US.

For many years now, the Federal Reserve has routinely hired noncitizens into highly paid professional positions without receiving approval from OPM.³³ In the FRB and some district Federal Reserve banks, a large share of the some segments of their professional staffs were hired as non-citizens, and the Fed provided these new employees with legal assistance to acquire the necessary work permits. In my opinion, the general public would be shocked by the number of noncitizens the Fed has hired for relatively senior staff positions during a period of sustained high unemployment among US citizens.

Thank you for the opportunity to testify today.

³² For further discussion see, Paul Kupiec “The money in banking: Comparing salaries of bank and bank regulatory employees.” <http://www.aei.org/publication/the-money-in-banking-comparing-salaries-of-bank-and-bank-regulatory-employees/>

³³ I managed FDIC new PhD economist recruiting for 10 years. The FDIC was prohibited from hiring non-US citizens for staff economist positions. Many of the new PhD non-US citizens I could not interview ended up employed by the Federal Reserve Board or in a Federal Reserve district bank.

“Preserving the Independence of the Federal Reserve”

Testimony of Alice M. Rivlin*

Hearing on “Fed Oversight: Lack of Transparency and Accountability”

Subcommittee on Oversight and Investigations

Committee on Financial Services

U.S. House of Representatives

Tuesday, July 14, 2015

Mr. Chairman and members of the Subcommittee:

The premise of this hearing appears to be that there is something mysteriously opaque about the Federal Reserve’s conduct of monetary policy; that some threat to our economy might unfold out of view of the public and Congress; that if another group of experts, say, a team from the Government Accountability Office (GAO) “audited” the Fed’s deliberations on monetary policy, we would learn something important and we would all be better off.

My views are quite different and I will make three basic points.

- **First, current monetary policy alternatives are controversial, but they are not mysterious or opaque, and Federal Reserve officials are making extraordinary efforts to explain to Congress and the public the dilemmas they face.**

When the economy plunged into deep recession after the financial crisis of 2008 the Federal Reserve engaged in aggressively accommodative monetary policy aimed at arresting the steep decline of economic activity and accelerating recovery. It brought short term interest rates close to zero and engaged in several rounds of bond-buying to put downward pressure on long-term rates and flood banks with reserves. As the economy recovered, the Fed phased out its bond purchase programs.

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Now the Fed must decide when to begin raising short-term interest rates and how fast bring those rates back to a more normal range. Like most monetary policy decisions, this one is a judgment call, and views differ, both inside and outside the Fed. The arguments for moving soon are that very low interest rates punish savers and invite excessive risk-taking; that the economy is strong enough to deal with higher rates and that the Fed needs to have rates back in a range where it can move in either direction. The arguments for waiting longer are that growth throughout the recovery has been slow, slack remains in labor markets, inflation is below target, and weakness in the international economy could affect U.S. growth negatively.

Different people weigh the factors differently, but there is nothing obscure or inscrutable about this dilemma. The FOMC minutes lay out the arguments. Chairman Yellen and other Fed officials explain their views frequently and lucidly in speeches. The Chairman testifies and answers endless questions both in hearings and in press conferences.

- **Second, nothing terrible or irreversible is likely to happen if the Fed acts too slowly or too fast. Threats to our future prosperity are more likely to come from fiscal gridlock.**

Some argue for higher rates on the grounds that inflationary dangers are lurking somewhere, but this fear seems extremely far-fetched to me. Even if labor markets were to tighten unexpectedly and wages began to rise faster, the Fed could counter any inflationary threat effectively by raising rates. Our economy is much less inflation-prone than a generation ago and there is no danger of inflation suddenly getting out of control.

Unfortunately, the more likely scenario for the foreseeable future is slow growth in the labor force combined with weak productivity growth. In such a world, reasonably accommodative monetary policy will continue to be appropriate, but is unlikely to be much help in spurring faster productivity growth.

Fiscal policy, by contrast, has a huge opportunity to improve our future prosperity by modernizing our decaying infrastructure, bolstering scientific research, and investing effectively in the skills of the labor force. Of course, views differ in the fiscal realm, as well. I believe near-term investment in future productivity growth should be balanced by long-term reductions in entitlement growth and increased revenues from a fairer, more pro-growth tax system. Resolving these questions is the responsibility of Congress and the President. In my opinion the greatest biggest danger to our long run economic health is that political gridlock prevents us from taking the fiscal steps that will maximize future prosperity.

- **Monetary policy decisions can be politically unpopular, and the creators of the Federal Reserve were wise to insulate those decisions from political pressures. Injecting another group into the mix to second guess monetary policy decisions would undermine an independent agency which is working hard to do the job Congress created it to do.**

The Fed is accountable to Congress and the public and is subject to thorough auditing and oversight of its operations. The campaign to “audit the Fed” is a misleading misnomer designed to suggest that the operations of the Federal Reserve are not subject to financial audit like other financial institutions. That is nonsense. The Fed’s books are audited by a major private sector accounting firm and scrutinized by the GAO.

The GAO is currently not allowed to examine the decision processes by which the Federal Open Market Committee reaches conclusions on monetary policy. Such a report would actually not be very interesting. It would say that the FOMC examines a lot of information about the outlook for the economy and projections of how that outlook might be affected by alternative changes in monetary policy. Members of the Committee express opinions on what to do. Then they vote. But we already know all that. The points of view expressed, although not the identity of the members expressing them, are faithfully recorded in the minutes.

If Congress were to inject another group of experts into the mix to second guess the FOMC as it sets monetary policy, it would politicize the process and undermine the independence of the Fed. That independence was created by Congress in part for its own self-protective reasons. Setting monetary policy is hard. Sometimes the right decision is unpopular. Members of Congress did not want the responsibility for those unpopular decisions, so they delegated them to a group of people selected for their expertise and protected from retaliation by long terms and other safeguards.

Delegating monetary policy to an independent body was a sound idea, and the Federal Reserve’s independence has become a model of central bank governance around the world. Independence in monetary policy setting must be accompanied by strong oversight of the Fed’s operations and frequent reporting on the Fed’s goals for monetary policy and how well they are being achieved. Those processes are now working well. My advice would be: leave well enough alone.

Thank you, Mr. Chairman and members of the Committee.

Recent Trends in Federal Reserve Transparency and Accountability

John B. Taylor¹

Testimony before the Subcommittee on Oversight and Investigations
Committee on Financial Services
U.S. House of Representatives

July 14, 2015

Chairman Duffy, Ranking Member Green and other members of the Subcommittee, thank you for inviting me to testify at this hearing on “Fed Oversight: Lack of Transparency and Accountability”

To address current concerns in Congress about a lack of transparency and accountability at the Fed—as expressed by the title of this hearing—it is useful to consider recent historical trends. As Ben Bernanke put it in 2008, “The Congress has also long been aware of the importance of Federal Reserve transparency and accountability. In particular, a series of resolutions and laws passed in the 1970s set clear policy objectives for the Federal Reserve and required it to provide regular reports and testimony to the Congress.”

One of the most important moves toward transparency and accountability in the past 25 years occurred in February 1994 when the Fed began to announce its target for the federal funds rate and to report publicly whenever it decided to increase it or decrease it. While Fed monetary policy decisions in the years before that were made in terms of a federal funds rate target, markets had to guess what the target was. The decisions were often communicated by the Fed through the financial press and Fed-watchers in vague and confusing ways, and the Fed was misinterpreted on a number of occasions. The lack of transparency gave an advantage to market

¹ Mary and Robert Raymond Professor of Economics at Stanford University, George P. Shultz Senior Fellow in Economics at Stanford’s Hoover Institution, former Under Secretary of Treasury for International Affairs, 2001-2005.

participants who could get some kind of information about what the decision was. It also adversely affected accountability to Congress and the public about what the Fed was doing, and made it difficult for economists outside the Fed, or people in “civil society” more generally, to comment or do research and analysis on Fed policy.² This 1994 transparency reform changed much of that.

The Fed took a number of additional steps to increase transparency in more recent years.³ In 2005 it cut the time between FOMC meetings and the release of minutes to three weeks, and by 2011 it was releasing economic and interest rate projections of FOMC members and holding quarterly press conferences with the Fed Chair.⁴ And in 2012, the Fed announced a numerical target of 2% for the inflation rate.

However, there have been important countervailing trends in transparency during this more recent period. For example, in 2000 the Fed stopped reporting its “ranges of growth or diminution of the money and credit aggregates,” for the current and upcoming year. The reporting requirements on the monetary and credit aggregates—first added to the Federal Reserve Act in 1977—were completely eliminated in the American Homeownership and Economic Opportunity Act of 2000. Thus in its Monetary Policy Report in July 2000, the Fed

² The fact that the Fed was not talking publicly about its settings for the federal funds rate back then was a source of confusion and much initial criticism over my design for a policy rule for the interest rate in the early 1990s.

³ By way of comparison economists have found that similar changes were occurring at other central banks. Using numerical indices of transparency, Dincer and Eichengreen (2014) considered 120 countries and found that from 1998 to 2010 only one central bank had a decrease in transparency, 109 had an increase, and ten had no change. The biggest increases were for central banks in emerging market countries—Hungary, Thailand, Turkey, and the Philippines. The central banks of Sweden, New Zealand, Hungary, Czech Republic, England, and Israel were the most transparent by this measure.

⁴ In recent years there also has been an increase in the number of speeches and commentary by members of the FOMC, but it is unclear whether this is an increase in transparency, and there is a reasonable argument that so many different voices create confusion.

simply reported that “the FOMC did not establish ranges for growth of money and debt in 2000 and 2001.” Labonte (2014) reports that the finding of Crowe and Meade (2008) that the Fed became less transparent from 1998 to 2006 can be traced to the Fed ending its reports on plans and outlook for money growth.

While the reduction in Fed transparency about its strategy for money growth might not seem significant in light of the difficulty of defining and measuring money, it is symptomatic of a broader lack of transparency about the Fed’s reporting its strategy for setting the instruments of monetary policy whether they are money growth, the federal funds rate, or the unconventional policy instruments such as quantitative easing, forward guidance or nascent macro-prudential tools.⁵

The inherent difficulty of devising a strategy for the unconventional instruments is one of the reasons the Fed has been reluctant to establish and report a strategy. When he was a Federal Reserve governor, Jeremy Stein stressed the importance of having a rules-based strategy for quantitative easing, but it was difficult because of uncertainty and disagreement about the impacts of quantitative easing on the economy.

There is another reason why the Fed may be reluctant to establish or be transparent about a strategy for the policy instruments, and the reason applies to all the instruments. It is the view that a strategy is not needed if the Fed has goals for the inflation rate or other variables; rather than have a strategy policymakers simply need to do what they think needs to be done with the policy instruments at each point in time. They do not need to articulate or describe a strategy, a decision rule, or a contingency plan for the instruments. But having a specific numerical goal or

⁵ Numerical transparency measures such as those used by Dincer and Eichengreen (2014) do not include information about macro prudential instruments.

objective is not a rule for the instruments of policy; it is not a strategy and it ends up being all tactics.

The Fed needs to have a systematic strategy and be clear about it if it is going to be transparent and accountable. As Charles Plosser (2014), former president of the Federal Reserve Bank of Philadelphia, put it: “transparency...could be enhanced if the central bank was more explicit in articulating its systematic approach to policy.”

Consider the Fed’s “Statement on Longer-Run Goals and Monetary Policy Strategy.” It sets the goal for inflation and employment, and it says that the Fed “seeks to mitigate deviations of inflation from its longer-run goal and deviations of employment from the Committee’s assessments of its maximum level” (goals respectively defined as an “inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption” and a “central tendency of 5.2 percent to 5.5 percent” for the unemployment rate).

So while the goals are stated, a strategy for achieving the goals is not, despite the appearance of the word “strategy” in title of the statement. Instead the Fed will apparently do as it sees fit in a discretionary way. As economists Michael Belongia and Peter Ireland (2015) put it “For all the talk about ‘transparency,’ ... the process—or rule—by which the FOMC intends to defend its two-percent inflation target remains unknown.” At the least the Fed should report on a rule or strategy it uses as a basis for policy decisions. As is well known from Fed transcripts, the Fed uses policy rules and discusses deviations from such rules, so the Fed should report them. It’s a matter of transparency.

The current situation creates a lack of transparency and an environment conducive to benefiting those with information at the expense of others without it. Controversy over the alleged leak of information about quantitative easing in October 2012 provides an example of the

problems caused by the discretionary nature of unconventional monetary policy. The decisions about quantitative easing are not something about which the timing, the amount, the path or the exit can be easily described as a strategy. Thus, there is less transparency. Instead there is a series of unpredictable discretionary tactical decisions, and knowledge of each one benefits market participants who can get it. If there were a clear and publically announced strategy for setting the policy instrument over time—as is possible in the case of a conventional instrument like the federal funds rate—then more information about policy would be available to all.

In sum, while changes at the Fed—such as the establishment and announcement of a numerical inflation goal—have increased transparency and accountability in recent years, reluctance to establish and announce a strategy to achieve this goal has created a countervailing trend. Requirements for the Fed to report its strategy for its policy instruments and other procedural reforms are needed to address the resulting lack of transparency and accountability.

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