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

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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.

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[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),

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[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 prevailed[5], 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 serves 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]

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[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, its 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

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[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 conductive 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

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[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.